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Recent developments in the securities law arena in India

Introduction

There is no global market which remained unaffected by the recent recession. The volatility in the markets resulted in forcing the great analysts to revisit their hereto standard norms and compelled the regulators to introduce or revise various regulations, systems and procedures controlling or managing both capital and financial markets. The Indian capital market was no exception and accordingly, this lead to the regulators of capital markets considering the existing norms. In India many major changes have been introduced in the recent past. In this article, we have discussed the recent important developments in the securities law in India and various issues related to those developments.

Recent developments

Mandatory 25 per cent minimum public shareholding

Presently, the much mooted issue in the Indian Securities Market is the recent amendment by the Ministry of Finance by Press Release F.No.5/35/2006-CM dated 4 June 2010. The Securities Contracts (Regulation) (Amendment) Rules 2010 ('SCRA Rules 2010'), released via the above mentioned Press Release, substitutes sub-rules (2) & (4) of Rule 19 by Rule 19A which makes it mandatory for every listed company to have a minimum threshold level of public shareholding of 25 per cent instead of ten per cent. The changes brought forth by the said amendment mean that:

- it is mandatory for listed companies to raise public shareholding to 25 per cent;
- all listed entities would have to dilute at least five per cent additional equity annually until they reach the 25 per cent limit; and
- fulfillment of this condition is a must to remain listed.

This move is in line with practices followed in developed economies globally. While the London Stock Exchange requires 25 per cent minimum public holding, the Singapore and Hong Kong Stock Exchanges also stipulate public shareholding of between 12 per cent and 25 per cent. Though the government notification is already in place, the debate remains since SEBI is yet to publish any circular on this matter. The implication of this change is argued from both sides by experts. One of the important positive implications affecting the securities markets by this amendment, observed by CRISIL (Credit Rating Information Services of India Limited), is that the amendment will significantly increase liquidity in the equity markets, make fair and reasonable price discovery more robust and enhance investor participation thereby implementing practices followed globally. The move will ensure sufficient float for investors as well as improve the quality of governance and help the government's divestment programme. But some are of the view that the said change needs to be revised since it is inconsistent with the prevailing regulations. The provisions for lock-in of a promoter's contribution under the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009 ('ICDR Regulations') require the promoter's contribution to the extent of 20 per cent of the total capital of the issuer to be locked-in for a period of three years and the promoter, holding in excess of 20 per cent, to be locked-in for one year from the time of listing. These conditions restrict the promoter of a newly-listed company from diluting his stake, thereby restricting the choice of instruments available to companies to step up to the minimum 25 per cent public shareholding requirement to a fresh issue of shares. Therefore, for companies planning a sale offer, the lock-in clauses need to be relaxed. Further, minimum public shareholding requirements stipulated in Part V of the ICDR Regulations, need to be amended in accordance with Rule 19 and 19A of the SCRA Rules 2010. Clause 82(b) of Chapter VIII of the ICDR Regulations bars companies from selling shares to institutions through a qualified institutional placement (QIP) within a year of having raised money from the market. This means promoters will have to sell shares either in the open market or through

a Follow-on Public Offer (FPOs), which is considered to be one of the most difficult routes for stake dilution, as excess supply in the market will create an overhang in stocks, putting pressure on the share price, thereby creating a depression in the secondary market. However, though in the short-term the new mandatory public shareholding requirement may create a bit of an overhang by enforcing dilution by promoters; in the long-run, the rule should be able to achieve the objective of creating much more efficient and deeper capital markets. Different people have different observations on the much mulled over amendment and it is yet to be seen whether the markets will be able to absorb the rush of public offers necessitated by the new norms and whether the debate between SEBI and the government comes to an end with a positive impact.

DIP versus ICDR

Amongst the other guidelines, the Securities Exchange Board of India (SEBI) issued Disclosure and Investor Protection Guidelines 2000 ('DIP guidelines') which have now been replaced by the ICDR Regulations as of a SEBI notification dated 26 August 2009. The ICDR Regulations are not a fresh law regulating the public issue of securities but an attempt by SEBI to streamline the framework for public issues by removing unnecessary stipulations and by adding clarity to the erstwhile DIP guidelines. Hereinafter only certain changes in the ICDR Regulations are discussed, owing to their practical repercussions and attributing to the changing phenomenon of the securities market arena in India. SEBI, with the objective of bringing about transparency in the mechanism of the markets, have made provisions for adequate disclosures and efficient procedures. The erstwhile DIP guidelines allowed two type of book building: 100 per cent book building and 75 per cent book building. However, the ICDR Regulations did away with the rarely opted 75 per cent book built route. Previously, the issue period was unclear in cases where there was a revision in the price band in a book building issue but the ICDR Regulations clarifies this lacuna and provides the total issue period to be a maximum of ten days including any revision in the price band. The 30 day period for the allotment/refund in case of fixed price issue have been replaced with a 15 day period to make the issue process speedier and accountable. The ICDR Regulations require that any pledge of shares by promoters should be disclosed in the prospectus for the public issue. This change is in line with the recent changes in the Equity Listing Agreement and in SEBI (Substantial Acquisitions of Shares and Takeovers) Regulations 1997 ('Takeover Code'). This information, coupled with the financial data, would give a reasonable indicator to the interested investor of the likelihood of the promoters losing control of the company to the lenders/lender nominees and thereby help investors in taking informed decisions. It is pertinent to note that the ICDR Regulations, with a view to strengthening corporate governance and transparency, has, by defining the key management personnel, group companies, employees etc, identified persons in the issue process thereby placing greater responsibilities on them. The exemptions with regards to the eligibility norms available to the banking companies, corresponding new banks and infrastructure companies under the former DIP guidelines have been removed and the regulations are made uniformly applicable to all types of issuers. This is a logical move since these companies are now competitive and do not need such a privilege.

The above mentioned ICDR Regulations have been amended on various occasions, primarily for corporate governance, allotment subscription and procedures.

Takeover Code – applicability of open offer obligation in ADR/GDR issue

SEBI has time and again come out with various circulars to regulate the securities market and to fulfil its endeavour of better corporate governance. In 2009, SEBI made certain amendments and issued certain clarifications to the Takeover Code and SEBI considered whether ADR/GDR documents can have clauses restraining their holders from exercising voting rights on the underlying shares. Further, if voting rights rest with the management, SEBI contemplated whether it amounts to acquisition of voting rights by persons in control in terms of the Takeover Code. In other words, will an open offer be triggered if voting rights go beyond the open-offer threshold? As per the law, the depository bank is registered and the shareholder has the voting right, while the eventual holder of the depository receipt does not have voting rights. In practice, however, while the issuance happened there prevailed an agreement between the issuer

and the depository bank giving 100 per cent control on the Indian board or the management in many cases to exercise the votes. Simply put, the depository bank was actually being deprived of its rights to vote in all such ADR/GDR issuances. The issue was taken up by SEBI at a time when negotiations between Bharti and MTN for a merger were in full swing. SEBI clarified that if ADR/GDR holders were entitled to exercise voting rights on the shares underlying ADR/GDR by virtue of clauses in the depositary agreement or otherwise, open offer obligations shall be triggered upon crossing the threshold limits as set out under the Takeover Code. Accordingly, necessary amendments to the Takeover Regulations were notified on 6 November 2009.

Further, SEBI via its interpretative circular dated 6 August 2009 clarified that under Regulation 11 (1) of the Takeover Code, the creeping acquisition of five per cent would be available subject to the condition that on post-acquisition, the shareholding/voting rights of the acquirer together with persons acting in concert with him, shall not increase beyond 55 per cent. However, such acquisition up to 55 per cent under Regulation 11(1) shall not be a bar on further acquisition up to five per cent as envisaged under the second proviso to Regulation 11 (2).

Prohibition on listed companies on issue of shares with superior voting rights

SEBI, via its circular dated 21 July 2009, laid down that no listed company can issue equity shares with superior rights as to voting or dividend. This will avoid the possible misuse by the persons in control to the detriment of public shareholders.

Foreign investment in India – new pricing valuation method on issue of shares to non-residents

Ministry of Finance and Reserve Bank of India (RBI) regulating, inter alia, the foreign investments in India has, in the recent notification dated 7 April 2010, notified the Foreign Exchange Management (Foreign Currency Accounts by a person resident in India) Amendment Regulations 2010 and made amendments relating to the pricing for new shares to be issued to a non-resident. In the case of unlisted companies, the pricing has been changed from CCI guidelines based valuation to discounted free cash flow (DCF) valuation carried out by a SEBI registered category-I merchant banker or chartered accountant.

Changes introduced through recent judicial pronouncements

A recent judgment rendered by the High Court of Bombay in February 2010, in the matter of *Western Maharashtra Development Corp Ltd v Bajaj Auto Limited*,[1] firmly establishes the fact that a public company in India cannot provide for restrictions on the transferability of its shares. It was observed that in joint ventures and collaborations, parties imposed certain restrictions on the rights of each other to deal in the shares of the joint venture company. Such restrictions took the form of right of first offer/refusal, pre-emptive rights, negative covenants and other similar contractual arrangements included within the shareholders agreements or other similar joint venture agreements between the parties. In the said judgment, Bombay High Court held (among other things) that in case of a 'public company', its shares are freely transferable under the Companies Act 1956 ('the Act') even if the Articles of Association ('Articles') contain restrictive provisions relating to the transfer of shares. An agreement creating a pre-emptive right in favour of one person to purchase the shares held by the other has the effect of imposing restriction on the free transferability of shares of a public company and is impermissible. The Honourable Court noted that section 111 A of the Act provides that the shares or debentures of a company and any interest therein shall be freely transferable and the Articles must yield to the principle of free transferability embodied in section 111 A and the preemptive right is inoperable. Further, section 9 of the Act stipulates that the provisions of the Act shall have effect, notwithstanding anything to the contrary contained in the memorandum or Articles. Therefore, the pre-emptive right recognised in the Agreement and incorporated in the Articles, must yield to section 111 A of the Act and the plain intendment and meaning of section 111 A must prevail. This decision will require public companies to reassess their Articles which contain restrictions on transfer of shares and debentures, such as the right of first refusal, tag-along rights, drag-along rights and other similar arrangements. The verdict will also have a bearing on the existing private equity (PE) deals as well as on the way future PE deals are structured since most involve

such clauses in the investment agreements. Recently, the above mentioned judgement has been overruled by a divisional bench of the High Court of Bombay judgement in the matter of Messer Holdings Limited v Shyam Madanmohan Riva & Ors.[2] Therefore, the legal position of the transferability of shares of public companies remains the same as it was before the abovementioned judgement of the single bench of the Bombay High Court. Comfort may be drawn from the fact that the Supreme Court has not yet settled this position of law. A balance must be drawn between a shareholders right to create obligations on himself with respect to his shares in a public company and the intent of section 111 A of the Act.

Amongst other judicial pronouncements, the Securities Appellate Tribunal (SAT) in its recent judgment dated 15 January 2010, in the matter of *M/s Subhkam Venture (I) Private Limited v SEBI,* passed an order setting to rest the long debated issue of 'control' as per the Takeover Code in terms of deal structure entered into by the private equity investors, and venture capitalists etc, wherein financial investors typically seek protection through specific rights such as the ability to appoint a nominee director, quorum rights at board and general meetings and, most importantly, certain supermajority or veto rights. The issue under consideration was whether the share subscription and shareholders agreement executed by and between Subhkam Holding Private Limited (Appellant), MSK Limited (Target Company) and its promoters gave the Appellant 'control' over the Target Company making it liable to make an open offer under Regulation 12 of the Takeover Code. SAT held that protective rights conferred on financial investors by virtue of the agreements by themselves are inadequate to constitute 'control' on the acquirer. At the outset, SAT laid down some general principles on what constitutes 'control' in such a situation involving a financial investor. Noteworthy is the distinction being made between proactive power (positive control) and reactive power (negative control). 'Control', according to the definition under the Takeover Code, is a proactive and not a reactive power. The importance of this SAT ruling is that it sets to rest an issue that had caused a great amount of consternation among investors, from being able to obtain customary contractual rights while undertaking the private equity transactions without the fear of inviting unintended consequences of becoming controllers of the target company. Still it is hard to assume that the last word has been said on the issue. The possibility of an appeal by SEBI cannot be discounted. Considering the importance of this issue, it is also reasonable to anticipate recommendations from the Takeover Regulations Advisory Committee.

Conclusion

From the above changes it is evident that both the regulators and the government have a clear vision for bringing the market to a level similar to those across the globe in terms of corporate governance, transparency and protection of investors' interests.

Notes

1 *Western Maharashtra Development Corp Ltd v Bajaj Auto Limited,* (2010) 154 Comp Cas 593 (Bom).

2 Messer Holdings Limited v Shyam Madanmohan Riva and Ors, (2010) 5 Bom CR589.