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Analysing developments impacting business

FRAMEWORK FOR ISSUANCE OF DIFFERENTIAL VOTING RIGHTS SHARES

5 July 2019

INTRODUCTION

In a welcome move towards enabling issuance and listing of shares with differential voting rights in India, the Securities and Exchange Board of India (SEBI) at the meeting of its board on 27 June 2019 approved a framework for enabling listing in India of companies with dual classes of shares, i.e. superior voting rights shares (SR - Shares) and ordinary shares (SR - Shares Framework). SEBI has approved the SR - Shares Framework in the backdrop of the ongoing debate on listing of Indian companies with shares having differential voting rights (DVRs) and the need for relaxing existing regulations to permit technology - based companies to access domestic capital markets with the promoter or founder of such company retaining control, akin to structures seen in the United States of America, Hong Kong, and other internationally recognized stock exchanges. In recent times, both the Hong Kong Stock Exchange and the Singapore Stock Exchange have permitted listing of companies having shares with DVRs. However, both exchanges permit only ordinary equity shares carrying one vote per share to be listed and offered to the public. Other classes of shares that carry DVRs cannot be offered to the public and must be held by shareholders as unlisted and untradeable.

KEY PROPOSALS BY SEBI

- A company with SR - Shares that intends to undertake an initial public offer of its ordinary shares (Issuer Company, and such initial public offer an IPO) is required to comply with certain eligibility conditions in addition to those prescribed under the existing Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 (SEBI ICDR Regulations). Set forth below are the key eligibility related proposals mooted by SEBI:
 - the Issuer Company must be a technology - based company, i.e., intensive in the use of technology, including information technology, biotechnology, nanotechnology, data analytics or intellectual property in order to provide products, services, or business platforms that create substantial value addition;
 - the member holding SR - Shares (SR Shareholder) should be a part of a promoter group whose collective net worth does not exceed INR 5,000 million. For the purpose of determining the collective net worth of the

promoter group, the investment of the SR Shareholders in the shares of the Issuer Company are not to be considered;

- the SR - Shares can be issued only to promoters or founders of the Issuer Company who hold executive position(s) in the Issuer Company;
- the SR - Shares should have been held by the promoters or founders of the Issuer Company for a period of at least six months before the filing of the red herring prospectus in connection with the IPO; and
- the issue of SR - Shares should have been authorized by a special resolution passed at a general meeting of the shareholders.

➤ ***Rights attached to SR - Shares***

The total voting rights exercised by SR Shareholders cannot exceed 74 per cent of the total voting share capital of the Company and no SR - Share can carry more than ten votes for every SR - Share held. Additionally, SR Shareholders will be treated at par with shareholders holding ordinary shares in all matters, except in relation to voting rights.

➤ ***Listing and Lock-in Restrictions***

SR - Shares are required to be listed on the stock exchanges after the Issuer Company has completed an IPO. All SR - Shares are to be subject to lock-in restrictions after completion of the IPO until such time that the SR - Shares have been converted to ordinary shares of the Issuer Company. Inter-se transfer of the SR - Shares among the promoters of the Issuer Company is not permitted during such lock-in period, and no pledge or other encumbrance can be created on SR - Shares.

➤ ***Enhanced Corporate Governance***

An Issuer Company is required to ensure that the audit committee constituted by its board of directors comprises only independent directors. Additionally: (a) the board of directors of such Issuer Company must consist of at least 50 per cent independent directors, and (b) other committees constituted by the board of directors must have independent directors constituting at least two thirds of its members.

➤ ***Coat-tail Provisions***

After the consummation of the IPO, the voting rights of an ordinary shareholder of the Issuer Company and an SR Shareholder will be considered to be identical in the following circumstances:

- appointment or removal of an independent director or the statutory auditor of the Issuer Company;
- voluntary transfer of control of the Issuer Company by the promoter in favour of another entity;
- approval of related party transactions, as defined under the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (SEBI Listing Regulations), involving an SR Shareholder;
- voluntary winding up of the Issuer Company;

- approval of any changes to the memorandum of association or the article of association of the Issuer Company, other than such changes that would affect the SR - Shares;
- initiation of a voluntary resolution plan under the Insolvency and Bankruptcy Code, 2016;
- utilization of funds for purposes other than in the ordinary course of business by the Issuer Company;
- approval of material transactions as determined in accordance with the materiality threshold prescribed under the SEBI Listing Regulations;
- approval of delisting or buy-back of shares of the Issuer Company; and
- such other provisions as may be notified by SEBI from time to time.

➤ **Sunset Clauses**

SR - Shares shall stand mandatorily converted into ordinary shares on the fifth anniversary of the listing of SR - Shares, unless extended for an additional period of five years by way of a resolution passed by the shareholders of the Issuer Company. It is pertinent to note that SR Shareholders will not be permitted to vote on such resolution. The SR - Shares Framework, however, does not specify if such resolution for extension of the SR - Shares must also be a special resolution.

SR - Shares automatically convert into ordinary shares upon the occurrence of certain material events including death or resignation of the SR Shareholder, or a merger or acquisition that results in the SR Shareholder relinquishing control over the Issuer Company.

ANALYSIS OF THE SR - SHARES FRAMEWORK

➤ **Tax treatment of SR - Shares upon conversion**

In terms of the Income Tax Act, 1961, conversion of compulsorily convertible preference shares into equity shares is an exempt transaction and accordingly would not be taxed. However, it is unclear as to whether such exemption would be available for the conversion of SR - Shares into ordinary shares, considering that both SR - Shares and ordinary shares will be equity shares, albeit of different classes.

➤ **Tenure of SR - Shares**

SR - Shares are intended to allow promoters or founders of an Issuer Company to exercise control over business activities for a certain period with the intention of catapulting technology - based companies to the next stage of growth. The five-year window proposed by SEBI appears to be restrictive and has the potential to hinder the vision of promoters or founders, as technology - based companies typically have a long gestation period. The business models followed by technology - based companies primarily focus on growing revenue, asset acquisition and its development, customer acquisition and outreach in the initial years. Considering that technology - based companies focus on long term goals rather than short term goals, it would be beneficial to extend the sunset clause to a longer tenure than the tenure currently proposed by the SR - Shares Framework.

➤ **Prohibition on inter-se transfer of locked-in SR – Shares among the promoters**

The SR – Shares Framework does not permit *inter-se* transfer of SR – Shares amongst the promoters or founders of the Issuer Company, until SR – Shares are converted into ordinary shares. However, it is pertinent to note that the SEBI ICDR Regulations offer flexibility by permitting transfer of locked-in securities amongst promoters of the Issuer Company. Accordingly, it would have been beneficial for the SR – Shares Framework to offer similar flexibility to the promoters or founders of the Issuer Company with respect to the SR – Shares as well.

➤ **Companies Act, 2013 and the Companies (Share Capital and Debentures) Rules, 2014**

The Companies Act, 2013 (Companies Act) and the Companies (Share Capital and Debentures) Rules, 2014 (Share Capital Rules) permit a public company to issue SR – Shares provided that, among others, it has distributable profits for the last three years. The requirement to demonstrate distributable profits for the last three years is a major impediment for technology – based companies to issue SR – Shares, as these companies tend to primarily focus on growing revenue, asset acquisition and its development, customer acquisition and outreach in the initial years. Additionally, the Share Capital Rules specify that the extent of voting rights attached to shares with DVRs cannot exceed 26 per cent of the total paid up equity share capital, which is contrary to the position set out under the SR – Shares Framework, which allows up to 74 per cent of the total voting share capital to be attached to SR – Shares, post listing. Accordingly, for successful implementation of the SR – Shares Framework, suitable amendments will have to be made to the aforesaid provisions of the Companies Act and the Share Capital Rules.

POTENTIAL AMENDMENTS TO VARIOUS SEBI REGULATIONS

In order to give effect to the SR – Shares Framework, certain amendments are required to be made to the SEBI Listing Regulations, Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (Takeover Regulations), and Securities Contracts (Regulations) Rules, 1957 (SCRR). Accordingly, set forth below are some of the key amendments that may be expected:

➤ **Amendments to the SCRR**

Pursuant to Rule 19(2)(b) of the SCRR, companies that have multiple classes of equity shares at the time of undertaking an IPO must make an offer of each such class of equity shares to the public during the IPO. Additionally, the minimum dilution and subscription requirements prescribed under the SCRR must be met for each class of equity shares issued by the company. Considering that as per the SR – Shares Framework, SR – Shares would be listed on the stock exchanges without the requirement of being offered to the public for subscription, suitable amendments will have to be made to the SCRR.

➤ **Amendments to the Takeover Regulations**

Regulation 3 of the Takeover Regulations requires an acquirer who acquires shares or voting rights in a listed company to make an open offer and public announcement thereof, when such acquisition, taken together with shares or voting rights already held by such acquirer and persons acting in concert with the acquirer, gives the acquirer the right to exercise 25 per cent or more of the voting rights in such listed company.

The conversion of SR – Shares into ordinary shares of the Issuer Company at the end of the prescribed term of five years, or upon the occurrence of certain events as highlighted above, may result in an increase in the voting rights exercisable by non-promoter shareholders (holding ordinary shares of the Issuer Company) beyond 25 per cent, triggering open offer and public announcement obligations. Accordingly, SEBI will be required to amend Regulation 10 of the Takeover Regulations to exempt non-promoter shareholders having 25 per cent or more voting rights due to the conversion of SR – Shares into ordinary shares from undertaking an open offer and a public announcement thereof under the Takeover Regulations.

➤ **Amendments to the SEBI Listing Regulations**

Regulation 41(3) of the SEBI Listing Regulations prohibits a listed company from issuing shares in any manner that might confer on any person superior rights in relation to voting or dividend vis-à-vis the rights attaching to equity shares that have already been listed. Accordingly, SEBI will be required to amend Regulation 41(3) of the SEBI Listing Regulations to permit listing of SR – Shares.

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