Article

SEBI enables listing of non convertible preference shares: Issues Regulations for public issues and listing of Non-Convertible Preference Shares

CS Nivedita Shankar
nivedita@vinodkothari.com
Vinod Kothari & Company
June 17, 2013

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In continuation to its press note PR No. 27/2013[1], the market regulator Securities Exchange Board of India ("**SEBI**") has notified the SEBI (Issue and Listing of Non-Convertible Redeemable Preference Shares) Regulations, 2013[2] ("**Regulations, 2013**") on June 12, 2013 by which SEBI seems to govern big issues of non convertible preference shares also. Preference shares, in general, are fairly common among the foreign investors, venture capital investors and so on as such instruments give preference in dividend and at the same time have other features of ordinary debentures[3]. Non convertible preference shares are replica of non convertible debentures and it is good that SEBI has taken step forward to enable the listing of non convertible preference shares.

NEED FOR THE REGULATIONS

Previously, the following two regulations were issued by SEBI for issue and listing of securities:

1. Securities And Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008 which is applicable to non-convertible debt securities which create or acknowledge indebtedness i.e. debentures, bonds etc but did not cover the non convertible preference shares. These Regulations defines a 'debt security' as:

   *"debt securities" means a **non-convertible debt securities which create or acknowledge indebtedness**, and include debenture, bonds and such other securities of a body corporate or any statutory body constituted by virtue of a legislation, whether constituting a charge on the assets of the body corporate or not, but excludes bonds issued by Government or such other bodies as may be specified by the Board , security receipts and securitized debt instruments"*

2. Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 which is applicable to convertible securities and equity shares of the issuer company. 'Convertible Security' has been defined in these Regulations as:
   *"convertible security" means a security which is convertible into or exchangeable with equity shares of the issuer at a later date, with or without the option of the holder of the security and includes convertible debt instrument and **convertible preference shares**"*

Both the above stated Regulations do not provide guidelines for non convertible preference shares. Thus, there were no regulations to govern the issue and/or listing of Non-Convertible Redeemable Preference Shares ("**NCRPS**") and with Regulations, 2013, SEBI has

[1] http://www.sebi.gov.in/sebiweb/home/detail/25447/yes/PR-SEBI-Board-Meeting

[2] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1371190341311.pdf\
[3] See our several write ups on debentures at: https://india-financing.com/staff-publications.html/capital-markets.html

tried to fill that gap. However, like the SEBI (Issue and Listing of Debt Securities) Regulations, 2008, the Regulations 2013 has limited applicability.

APPLICABILITY

The Regulations, 2013 are applicable to:

1. public issuance of NCRPS; or
2. listing of NCRPS issued through public issue or on private placement basis by the public companies.
3. issuance and listing of Perpetual Non-Cumulative Preference Shares and Innovative Perpetual Debt Instruments by banks. Such instruments shall be made subject to the prior approval and in compliance with the guidelines issued by Reserve Bank of India.

Thus, effectively, the essence of Regulations, 2013 is to:

a. regulate the public issues of NCRPS
b. provide and permit listing of NCRPS which are issued by public companies- whether on private placement basis or as public issue.

Before discussing the scope and impact of the Regulations, 2013, it is important to know what a NCRPS is.

WHAT ARE NON-CONVERTIBLE PREFERENCE SHARES?

The Companies Act, 1956 has defined a 'preference share' only and before the issue of Regulations, 2013, as such there was no definition of NCRPS anywhere. Though Sections 80 and 80A deal with redeemable preference shares but issue of NCRPS was not tightly regulated by any authority- MCA or SEBI.

Regulations, 2013 has now defined RNCPS as:

> *"**Redeemable Non Convertible Preference Shares** means a preference share which is redeemable in accordance with the provisions of the Companies Act, 1956 and does not include a preference share which is convertible into or exchangeable with equity shares of the issuer at a later date, with or without the option of the holder"*

Thus, companies are now required to comply with the provisions the Regulations 2013 in addition to provisions of Companies Act (especially sections 80 and 80A). It is pertinent to note that pursuant to Section 87(2)(b) of the Act, in case of non-payment of dividend in respect of a period of not less than two years ending with the expiry of the financial year immediately preceding the commencement of the meeting or in respect of an aggregate period of not less than three years comprised in the six years ending with the expiry of the financial year aforesaid, such preference shares shall attain voting rights. Thus, keeping the

Act and Regulations, 2013 in perspective, in case issuing companies fail to pay dividend, such RNCPS shall carry voting rights. Acquisition of voting rights under such circumstances, however, would not mean that the preference shares have been converted into equity shares of that company. Such preference shares, therefore, even after acquiring voting rights pursuant to section 87(2) shall be non-convertible only.

ARE NON CONVERTIBLE PREFERENCE SHARES AND NON CONVERTIBLE DEBENTURES SAME?

RNCPS at times are also known as quasi debt instruments as it is a hybrid between equity and a debt instrument. The position of a non convertible preference shares is more or less similar to that of a non convertible debentures (NCDs) except and so far as explained here. As the name suggests, preference shares get preferential rights over dividend and repayment of capital at the time of winding up. Preference shares may acquire voting rights in terms of section 87(2) of the Companies Act as explained in preceding para. However, on the other hand, NCD is a pure form of a debt instrument, the holder of which neither acquires any voting rights (except in the matters of their concern) nor is given any preference at the time of redemption of debentures or winding up of the company. Preference shares form part of share capital of a company and can be issued by any company subject to compliance with applicable provisions of Companies Act, while, NCDs are debt instruments and cannot be issued by private companies if such debentures are unsecured and are public deposits in terms of Companies (Acceptance of Public Deposits) Rules.

A RNCPS and an NCD, however, are treated at par for foreign direct investment and FEMA purposes and both are regulated and governed by External Commercial Borrowings (ECB) Guidelines as issued by RBI from time to time.

SOME KEY DEFINITIONS IN THE REGULATIONS, 2013

Issuer

Any public company, PSU, statutory corporation

Promoter

As defined in SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

Public issue

Means offer or invitation to public to subscribe which is not private placement

Offer document

Prospectus and includes any such document or advertisement whereby the subscription to non-convertible redeemable preference shares are invited by the issuer from public;

"Part of the same group" and "under the same management"

As in explanation to regulation 23 of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009. This is provided in Regulation 4

REQUIREMENTS FOR PUBLIC ISSUE

The Regulations, 2013 has listed down the pre-requisites for making public issue. We list below some of the drafting irregularities:

1. Requirement for credit rating

   The Regulations, 2013 require credit rating of not less than "AA-" by a SEBI registered credit rating agency to be obtained. Such ratings shall be disclosed in the offer document.

   This requirement in itself is peculiar. Credit rating for any instrument is done to see its credit worthiness. However, to prescribe such a requirement for a preference share is absurd as how will the credit rating agency at all assess the profitability of a company? Projections can be used but they shall remain *projections* only and actual indicators.

2. Issuer to create a capital redemption reserve in accordance with Companies Act, 1956.

   This again seems to be completely redundant requirement. Section 80(1)(d) of the Act requires every company to create a capital redemption reserve in case the company decides to redeem the preference shares from other than a fresh issue.

Thus, such a decision cannot be taken at the time of issue itself but closer to the time of redemption. With Regulations, 2013, SEBI has stated that issuer has to compulsorily create a capital redemption reserve and by adding that this shall be "in accordance with Companies Act, 1956", SEBI has created ambiguity as the Act does not mandatorily require to create a capital redemption reserve and the language of Regulations, 2013 gives an impression it is mandatory.

3. End use restrictions

The issuer company has been prohibited from issuing RNCPS for providing loan to or acquisition of shares of any person who is part of the same group or who is under the same management, other than to subsidiaries of the issuer. With this, SEBI has intended to put end use restrictions on the use of proceeds from NCRPS, which is peculiar. Being in the nature of a quasi- debt, preference shares are issued to infuse funds in its operations. By restricting the scope of use of the proceeds, the Regulations, 2013 shall be out of the ambit of many closely held companies.

STEP-BY-STEP PROCEDURE

A. **Disclosures in offer document**

1. disclosures as in Schedule II of the Act and Schedule I of Regulations, 2013 which inter-alia include:
2. all material disclosures necessary to make an informed decision.

B. **Filing of draft offer document**

1. prior to this, due diligence certificate to be issued by the merchant banker as per Schedule II of Regulations, 2013
2. draft offer document to be filed by lead merchant banker and posted on the website of designated stock exchange, issuer company and merchant banker
3. all comments received on draft offer document to be addressed before filing of offer document with Registrar of Companies
4. draft and final offer document to be forwarded to SEBI and designated stock exchange simultaneously.

C. **Advertisements for public issues**

1. Issuer to make advertisement in one English national daily newspaper and one Hindi national daily newspaper with wide circulation at the place where the registered office of the issuer is situated, on or before the issue opening date of the issue.

The Regulations, 2013 has inserted a peculiar requirement of placing advertisements in Hindi newspapers compulsorily. The idea behind placing advertisements is to ensure maximize reach. However, by specifically stating that advertisement should be in a Hindi national daily newspaper, the purpose of ensuring maximum reach shall stand restricted in non-Hindi speaking states.

2. The advertisement shall urge the investors to invest only on the basis of information contained in the offer document.
3. Any corporate or product advertisement issued by the issuer during the subscription period shall not make any reference to the issue of non-convertible redeemable preference shares or be used for solicitation
4. Advertisement to also disclose all information as per Schedule I to the Regulations, 2013

D. **Abridged Prospectus and application forms**

It shall be the duty of the issuer and lead merchant banker to ensure that:

1. every application form issued by the issuer is accompanied by a copy of the abridged prospectus;
2. the abridged prospectus shall not contain matters which are extraneous to the contents of the prospectus;
3. adequate space shall be provided in the application form to enable the investors to fill in various details like name, address, etc

The Regulations, 2013 allow issuers to provide the facility of electronic mode for subscription of applications.

E. **Pricing of the Issue**

1. Price of non-convertible redeemable preference shares may be at a fixed price or determined through book building process.
2. Issuer to decide the amount of minimum subscription. On non-receipt of the same, all application money is to be refunded. Interest shall be levied @15% p.a. in case the application money are refunded after 8 (eight) days from the last day of offer.

F. **Other important points**

1. The issue can also be underwritten and in such a case sufficient disclosures regarding underwriting arrangements shall be made in the offer document.
2. Redemption period shall be a minimum of 3 years

REQUIREMENTS FOR LISTING

The Regulations, 2013 prescribe mandatory listing for all issuers making public offer. Unlike the SEBI (Issue and Listing of Debt Securities) Regulations which prescribes the guidelines only when the issuer wants to get its debt securities listed, the Regulations 2013 mandates every public issue of RNCPS to be listed in accordance with these Regulations.

KEY PRE-REQUISITES FOR LISTING

1. Preference Shares are in dematerialized form
2. Minimum application size for each investor is not less than Rs. 10 lakhs (applicable in case of listing of privately placed RNCPS).
3. Disclosures to be made as specified in Schedule I of Regulations, 2013 like Memorandum and Articles of Association, audited annual reports, date and parties to all material contracts. Detailed information regarding the issuer to be also provided as in Schedule I.
4. Listing application to be made within 15 days from the date of allotment of RNCPS if the issuer company is desirous of getting its privately placed RNCPS listed.
5. A separate listing agreement may be notified soon by SEBI/ stock exchanges

TRADING OF NON-CONVERTIBLE REDEEMABLE PREFERENCE SHARES

The Regulations, 2013 have also laid down conditions for trading of preference shares whereby, the shares shall be traded and such trades shall be cleared and settled in recognized stock exchanges. In case of OTCs, such trades shall be reported on a recognized stock exchange.

FOREIGN INVESTMENTS IN RNCPS: PROVISIONS OF FEMA

With Regulations, 2013 prescribing companies to get RNCPS listed, it opens up additional avenue for listing, not only for Indian residents, but also for foreign investors. However, the extant norms relating to foreign direct investment in India, does not allow Indian companies to issue non-convertible preference shares to foreign investors. In fact in terms of para 3.3.2 of the Consolidated FDI Policy issued by Department of Industrial Policy and Promotion effective from April 5, 2013, any issue of non-convertible preference shares shall be taken to be debt and accordingly, norms relating to External Commercial Borrowings shall be applicable.

TAXABILITY OF INCOME FROM RNCPS

The companies are required to pay dividend distribution tax (DDT) for the dividends distributed on the RNCPS and such dividend income is exempted in the hands of the investors. At the time of redemption, as it is extinguishment of rights on part of investors, capital gain will arise and capital gain tax is to be paid by the investors.

Our Analysis

What is conspicuously missing in Regulations, 2013 is any penal provision. It is thus, understood that penal provisions as in SEBI Act, 1991 will be applicable. Another pertinent point is that the applicability para of Regulations, 2013 only permits the listing of public issue of RNCPS, however, the conditions and other regulations suggest that SEBI has mandated all public issues of RNCPS to get listed and the permission is for privately placed issues only. In the coming months, we can also expect RBI to come up with its own set of regulations for banks as applicable under Regulations, 2013. The Regulations, 2013 however has given HNIs a reason to rejoice with SEBI giving them one more avenue to invest. With regulations being issued and reports indicating that Indian companies have raised over Rs 25,000 crore through preference share issuance in the last three years[4], this trend can be expected to catch up.

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- *Several Articles on debentures and debenture market in India at:* https://india-financing.com/staff-publications.html/capital-markets.html
- *Primer on Debentures at:* https://india-financing.com/Primer_on_debentures.pdf
- *Article on draft guidelines issued for issue and listing of redeemable preference shares:* https://india-financing.com/SEBI_approves_Regulations_for_issue_and_listing_of_non_convertible_redeemable_preference_shares.pdf
- *Article on Lending Against Shares:* https://india-financing.com/Article%20on%20Legal_Aspects_of_loan_against_shares.pdf
- *Other articles, presentations and notes on corporate laws and SEBI Regulations at:* https://india-financing.com/staff-publications-corporate-law.html

[4] http://businesstoday.intoday.in/story/sebi-sets-new-norms-for-listing-of-preference-shares/1/193152.html