

**[2022] 139 taxmann.com 439 (Article)**

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Date of Publishing: **June 23, 2022**

## **Preferential Allotment of Securities vis a vis SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018**



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A public company can issue securities in any of the following manners:

- (1) To public by way of issuance of prospectus also known as public offer; or
- (2) Through private placement; or
- (3) Through a rights issue or bonus issue.

Section 23 of the Companies Act, 2013 (CoA) is an enabling provision for public companies to raise funds in the form of equity or hybrid instruments, viz. fully convertible debentures, partly convertible debentures, or any other securities like convertible preference shares or debentures, warrants, which will be converted into or exchanged with equity shares at a later date<sup>1</sup>.

Clause (b) of sub-section 1 of section 23 mandates that, in case of a private placement of securities, a public company also needs to comply with part II of Chapter III of CoA, consisting of a lone section 42 which

deals with procedural aspects of "Offer or invitation for subscription of Securities on Private Placement". Listed companies making preferential allotment of securities or private placement of securities, need to comply with SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ("SEBI(ICD)R"). Chapter V of SEBI (ICD)R extensively deals with the Preferential Issue.

SEBI vide notification No. SEBI/LAD-NRO/GN/ 2022/ 63 dated January 14, 2022, has issued amendment regulations amending the SEBI (ICD) R thereby making various amendments to the preferential issue of securities. These amendments reduce the lock-in requirement of pre and post-shareholding of allottees, period of trading history in calculating pricing of equity shares, etc. Before this amendment, Regulation 163 of the SEBI (ICD) R, mandated the placing of the certificate issued by the Statutory Auditor before the general meeting of the company and called for consideration of the preferential issue. The amendment has now mandated that this certificate shall be issued by a practicing company secretary' instead of a Statutory Auditor.

### **Private placement vis a vis preferential issue**

Two different sections deal with Private Placement and Preferential allotment under the Companies Act 2013 viz. Section 42 and Section 62. Section 42 is an enabling provision for the issuance of any securities through the mode of the private placement to a select group of persons identified by the Board of the Company. Private placement as defined in Explanation I to subsection 3 of section 42 of the Companies Act, means any offer or invitation to subscribe or issue securities to a select group of persons by a company (other than by way of public offer) through private placement offer-cum-application, which satisfies the conditions specified in that section.

As per section 62, a company having a share capital may increase its share capital through various modes like

- (a) Issue of shares to existing shareholders as rights issue;
- (b) Issue of shares as ESOP to employees of the company;
- (c) Issue of shares to any person, including shareholder of the company or not, by way of passing a special resolution.

According to the explanation provided to sub-rule 1 of rule 13 of Companies (Share Capital and Debentures) Rules, 2014, 'Preferential

'Offer' means an issue of shares or other securities, by a company to any select person or group of persons on a preferential basis and does not include shares or other securities offered through a public issue, rights issue, employee stock option scheme, employee stock purchase scheme or an issue of sweat equity shares or bonus shares or depository receipts issued in a country outside India or foreign securities.

In conclusion, a company may issue any securities as per provisions of Section 42 of CoA and shares or instruments convertible in shares can be issued under Section 62 of CoA.

### **Further issue of capital on a preferential basis by Listed Company**

SEBI (ICD) R defines the preferential issue and according to clause (nn) of sub-regulation 1 of Regulation 2 of SEBI (ICD) R ("these regulations"), "preferential issue" means an issue of specified securities<sup>2</sup> by a listed issuer to any select person or group of persons on a private placement basis in accordance with Chapter V ("this chapter") of these regulations. However, it does not include an offer of specified securities<sup>[2]</sup> made through an employee stock option scheme, employee stock purchase scheme or an issue of sweat equity shares or depository receipts issued in a country outside India or foreign securities.

### **Non-applicability of provisions of Chapter V**

As per Regulation 158,

(1) Preferential issue made in the following circumstances are exempt from applicability of these provisions:

- (a) Conversion of loan or optionally convertible debt instruments into equity shares;
- (b) A scheme of Merger/ Amalgamation as approved by HC/ NCLT;
- (c) Issuance of shares made to qualified institutions.

(2) In case of the preferential issue made pursuant

- (a) to rehabilitation scheme as approved by the Board of Industrial and Financial Reconstruction under the Sick

- Industrial Companies (Special Provisions) Act, 1985; or
- (b) Resolution plan approved under Insolvency and Bankruptcy Code, 2016; or
  - (c) shares are issued to any financial institutions within the provisions of Recovery of Debts due to Banks and Financial Institutions Act, 1993; or

Provisions relating to lock-in of pre and post-preferential shareholding are not applicable.

- (3) The provisions relating to disclosures to be made to shareholders and pricing of securities to be allotted are not applicable in case of a preferential issue made by a company availing exemptions under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.
- (4) Certain provisions of this chapter are not applicable if the allotment is made on the conversion of loan as directed by RBI or if the allotment is made to a mutual fund or insurance company.

### **Ineligible Issuers and participants in Preferential Issue**

Part I of the chapter deals with issuers ineligible to make a preferential issue. The name of this chapter should have been "Ineligibility to make and participate in Preferential Issue"

According to Regulation 159,

- (a) Any person who has sold its pre preferential holdings, 90 days before the relevant date shall become ineligible to participate in the preferential issue of specified securities. If a person is belonging to a promoter or promoter group, has made an inter se transfer of shares as per take over regulations or transfer is due to invocation of pledge, the above restrictions are not applicable.
- (b) Any person who has failed to convert warrants into equity shares shall be ineligible to participate in the preferential issue of securities for one year from the date of expiry of the tenure of the warrants or date of cancellation of warrants, as the case may be.

- (c) The issuer shall be ineligible to make preferential allotment if any of the Promoters or directors of the issuer is a fugitive economic offender.
- (d) The issuer who has not paid outstanding dues to SEBI, stock exchanges, or depositories shall be ineligible to make preferential allotment.

### **Conditions for Preferential Issue**

Part II of this chapter deals with Conditions for the preferential issue and also defines "relevant date".

According to Regulations 160 every listed issuer making preferential issue of specified securities shall ensure the following things:

- (a) All equity shares allotted by preferential mode shall be made fully paid at the time of allotment.
- (b) A special resolution for allotment of securities on preferential basis shall be passed by shareholders of the issuer.
- (c) Seek an in-principle approval from all the stock exchanges, where it is listed.
- (d) All the existing securities of the proposed allottees must be in dematerialized form.
- (e) Proposed allottees must hold PAN or should be under the exempt category from holding PAN for transacting in the securities market.
- (f) The issuer shall comply with conditions of continuous listing of equity shares.
- (g) The "in-principle" approval stated in point (c) above shall be made on the same day on which notice convening a general meeting of the company for approving preferential allotment is sent to shareholders of the company. It may be noted that a special resolution needs to be passed at the convened general meeting.

### **Relevant Date**

Regulation 161 defines, the relevant date as follows:

- (a) In case of preferential issue of equity shares, the date 30 days prior to the date on which the meeting of shareholders it to be

held for approving preferential issue.

- (b) In case of issue of specified securities under any resolution of stressed assets as specified by RBI or a resolution plan as approved by NCLT, such date shall be the relevant date.
- (c) In the case of shares pursuant to convertible securities, the relevant date shall be the date 30 days prior to the date on which the meeting of shareholders is to be held for approving preferential issue or date 30 days prior to the date on which holders of convertible securities becomes entitled to apply for equity shares.
- (d) It may be noted that if a relevant date falls on a weekend or a holiday, the preceding day shall be the relevant date.

### **Tenure of Convertible Securities**

Listed entities may issue specified securities on a preferential basis. As per clause (eee) of sub-regulation 1 of regulation 2 of SEBI (ICD) R, "specified securities" means equity shares and convertible securities. According to regulation 162, the tenure of convertible securities shall not be more than 18 months from the date of their allotment. The issuer is also required to allot equity shares within 15 days of the exercise of the option to convert securities into equity shares.

### **Disclosures to Shareholders**

According to rule 13 of the Companies (Share Capital and Debentures) Rules, 2014, the issuer making preferential allotment shall ensure that:

- (1) The issue is authorized by its Articles of Association and its post allotment capital is within the Authorized Capital limit.
- (2) The issue is approved by way of passing of special resolution. The explanatory statement annexed to the notice convening general meeting should consist of:-
  - a. objects of the issue;
  - b. a total number of securities to be issued,
  - c. price or price band (and its basis) of the securities (in case of convertible instruments, conversion price at which equity shares shall be issued) to be issued, and,
  - d. relevant date,
  - e. names of person or persons to whom allotment of

securities shall be made and % of shares to be held by the post preferential allotment,

- f.* promoter or KMPs intention of making a subscription to preferential issue, sub sequential change in control, if any,
- g.* details of allotment made against consideration other than cash,
- h.* pre and post allotment on preferential basis shareholding pattern, in the prescribed manner,
- i.* period within which preferential allotment shall be made not exceeding 12 months from the date of special resolution.

- (3) Price of securities to be issued on a preferential basis shall not be less than the valuation report In the case of listed company pricing of preferential allotment shall be decided according to Regulations 164 to 166A of SEBI (ICD) R.

Apart from the above requirements prescribed under CoA, the listed issuer company shall also comply with provisions of regulation 163of the SEBI (ICD) R. As per regulation 163, the issuer Company shall also disclose following in the explanatory statement to the notice for the general meeting:-

- (a)* Identity of the natural persons who are ultimate beneficial owners (UBO) of the shares to be allotted. However, if the allottees are mutual funds, scheduled commercial banks or insurance companies, this disclosure is not required.
- (b)* Issuer's undertaking that pricing of specified securities shall be recomputed if required under the instant regulations.
- (c)* Issuer's undertaking that the shares shall be kept under lock in provided recomputed price is not paid for the issue.
- (d)* Disclosures, as specified in schedule VI, if the directors or promoters are willful, defaulted or fraudulent borrowers.
- (e)* The current and proposed status of allottees i.e. promoter or non-promoter.

- (f) The special resolution shall clearly specify the relevant date basis on which equity shares shall be allotted on conversion or exchange of convertible securities.

Specified securities may also be issued on a preferential basis for consideration other than cash. It may be noted that, if any of the stock exchanges, is not satisfied with the appropriateness of the valuation done by the company, it may seek all the necessary information from the issuer for determining the appropriate valuation of the preferential allotment of securities.

### **Pricing of Preferential Issue**

Regulations 164 to 166A deal with the pricing of securities allotted on a preferential basis. This prescribes various circumstances under which pricing of frequently traded shares is required to be arrived at. Volume weighted average price (VWAP<sup>3</sup>) is to be considered for arriving at the price of the preferential issue of the related equity shares. The pricing of equity shares shall not be less than VWAP <sup>[4]</sup> of the related equity shares for a period of 90 days or 10 days previous to the relevant date.

If the shares of a listed company are listed for a period of less than 90 days, the pricing shall be higher of IPO price/ Price at which shares are allotted pursuant to the compromise or arrangement scheme or average VWAP for the period for which shares are listed on the stock exchange or 10 trading days average VWAP during the two weeks preceding the relevant date.

If in case Articles of the Association of the issuer company provides for the methodology of calculating floor price, which is higher, the same shall be considered by the Company.

If the preferential issue is made to less than 5 qualified institutional buyers (QIB), the price shall not be less than the 10 trading days VWAP of the related securities listed on the recognized stock exchange. The QIBs to whom the allotment is to be made should not be promoters or related to promoters. For this purpose QIB holding rights under the shareholders agreement, veto rights, and right to appoint nominee directors are deemed to be a related party.

Regulation 164A deals with Pricing in the preferential issue of shares of companies having stressed assets.



The pricing method prescribed under regulation 164B can be availed by issuers for preferential allotment made between July 1, 2020 and December 31, 2020. The price of equity shares calculated under this regulation shall not be less than the average of the weekly high and low of the VWAP of the related equity shares during 12 weeks or 2 weeks preceding the relevant date. All the specified securities i.e. shares, securities convertible into equity shares at a later date, etc, shall be locked in for a period of 3 years from the date of issue. It is to be noted that the same pricing shall be followed by allottees in case of allotment made under a particular preferential issue.

In case of infrequently traded shares, an independent registered valuer shall certify the pricing after taking into account book value, comparable trading multiples, and such other valuation parameters. (Regulation 165)

While arriving at pricing for a preferential issue necessary adjustments shall be made, if the issuers have effected any of the following transactions:

- (a) issue of equity shares by way of capitalization of profits or reserves;
- (b) issue of equity shares after completion of a demerger;
- (c) rights issue of equity shares;
- (d) Consolation or subdivision or reclassification of shares.

### **Lock-in**

Part V and Regulation 167, 167A, and 168 provide for lock in and restrictions on the transferability of specified securities issued on a preferential basis. Lock-in indicates a freeze on the transfer of shares. These regulations also prescribe for lock-in of pre preferential shareholding of the allotted in certain circumstances, which are as follows:-

- (1) Specified securities or equity shares allotted on conversion of warrants shall be under lock-in for a period of 18 months from the date of grant of trading approval by the stock exchanges to issued securities, in case, if the same are issued to promoter or promoter group. If the specified securities or equity shares are allotted to a person other than the promoter

or promoter group the lock-in period shall be 6 months from the date of trading approval.

- (2) Not more than 24% of the issued capital shall be under lock-in for 18 months. But equity shares allotted in excess of 24% shall be locked in for a period of 6 months from the date of receipt of trading approval.
- (3) All the unlisted convertible securities shall be under lock-in for a period of one year from the date of allotment.
- (4) Lock in requirements, for equity shares issued on conversion of warrants shall be reduced to the extent of convertible securities already locked in.
- (5) Equity shares issued pursuant to directions issued by RBI or pursuant to resolution plan as approved by NCLT under IBC shall be locked for a period of 1 year.
- (6) To maintain 10% public shareholding, lock-in provisions shall be applicable accordingly with respect to specified securities.
- (7) The entire pre-preferential allotment shareholding of the allottees shall be locked in from the relevant date up to 90 trading days from the date of trading approval. In case of convertible securities, pre preferential shareholding shall be locked in from the relevant date till the date up to a period of 90 trading days from the date of trading approval.
- (8) Pledging of locked in specified securities held by the promoters as collateral for availing of loan is permitted provided the same is condition precedent for availing of the loan.
- (9) Inter-se transfer of specified securities amongst promoters or promoter group or to a new promoter or persons in control of the issuer is permitted subject to Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and continuation of lock in requirements under this regulation. It may also be noted that without granting trading approval no such transfers shall be permitted.

## **CONSIDERATION AND ALLOTMENT**

Regulations 169 and 170 deal with consideration and allotment of specified securities issued on a preferential basis. The consideration amount shall be paid in full by the allottees before allotment of

specified securities except in the case of issuance of warrants or shares issued for a consideration other than cash. In case of allotment of convertible warrants, minimum of 25% of the consideration shall be paid and the remaining amount shall be paid on the conversion of warrants into equity shares. If the allotment is made pursuant to the directions issued by RBI on the conversion of loan or resolution process approved by NCLT under IBC, the consideration amount shall be as per the plan approved by RBI and NCLT, respectively. Non-exercise of option to convert convertible instrument in shares will result in forfeiture of the amount paid at the time of allotment of such instrument. The issuer is required to submit a certificate from a statutory auditor certifying receipt of consideration against the issuance of preferential allotment of specified securities.

Allotment of securities issued on a preferential basis shall be completed within 15 days from the date of passing of such resolution. If in case, preferential allotment is subject to any regulatory approval like the period of 15 days will be extended accordingly. The issuer company shall make allotment of shares under preferential allotment compulsorily in dematerialized form.

### **Certificate of compliance by Practising Company Secretary**

With effect from January 14, 2022, and according to regulation 163, every issuer making preferential allotment is required to place before the General Meeting in which preferential allotment is considered, a certificate from practicing company secretary certifying that the issue is being made in accordance with the requirements of these regulations. The issuer is also required to host this certificate on its website.

### **Conclusion**

Preferential allotment of securities is an easier route available to listed entities for raising capital from the existing promoters and or select individuals/ entities. SEBI by way of provisions of Chapter V, ensures that this easier route is not misused by delinquent issuers to liquidate the equity stakes of gullible investors.



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1. Clause (ii) of Rule 13 Companies (Share Capital and Debentures) Rules, 2014 of the expression, "shares or other securities" means equity shares, fully convertible debentures, partly convertible debentures or any other securities, which would be convertible into or exchanged with equity shares at a later date.
  2. According to sub clause (eee) of clause 1 of Regulation 2 of SEBI (ICD) R, "specified securities" means equity shares and convertible securities;
  3. 
$$VWAP = \frac{\sum Price * Volume}{\sum Volume}$$