

SEBI's New Initiative: Framework for issuance of DVR shares, amendment to PIT Regulations & Takeover Code

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SEBI's New Initiative: Framework for issuance of DVR shares, amendment to PIT Regulations & Takeover Code

The SEBI Board¹, in its meeting held on June 27, 2019, took some important decisions on crucial matters relating to securities market. The SEBI Board resolved to roll out a framework for issuance of equity shares with differential voting rights, related party transactions w.r.t. payment of relating to royalty and brand usage, proposal to include the definition of 'encumbrance' in Takeover Code and introduction of disclosure mechanism for encumbrances on shares by promoters / Persons acting in concert. The SEBI Board proposed to amend SEBI (Prohibition of Insider Trading) Regulations, 2015 w.r.t. closure of trading window from the end of every quarter till 48 hours after declaration of financial results. The SEBI Board also reviewed the risk management framework of liquid funds, investment norms and valuation of money market and debt securities by mutual fund.

This article is a compilation of the decisions taken by the SEBI Board and its impact on the securities market, its intermediaries and compliances.

Framework for Issuance of Differential Voting Rights (DVR) Shares

As the shares with differential voting rights ('DVRs') have rights disproportionate to their economic ownership, the SEBI Board noted that there is an increasing debate about the need to enable issuance and listing of such shares. The SEBI Board approved the framework for issuance of the DVR shares by a listed company. The Board noted important conditions for such issue of shares, which includes eligibility criteria of companies for IPO, listing and lock-in of such shares, rights of such shares, enhanced corporate governance norms, treatment of DVR shares as normal shares (i.e. no superior rights) in certain circumstances. SEBI Board has also taken note of certain circumstances or events wherein DVR shares shall be converted into ordinary shares.

The decision of the SEBI Board w.r.t. the 'coat-tail' provision is very important from an equity shareholder or shareholder not holding equity DVR shares. According to the SEBI Press Release, in following circumstances (just an illustrative list), the DVR shares shall be treated as ordinary equity shares:

- (i) Appointment or removal of independent directors,
- (ii) Appointment or removal of auditor,
- (iii) Instances where promoter is willingly transferring control to another entity,
- (iv) Related party transactions in terms of SEBI Listing Regulations involving DVR shareholder,
- (v) Voluntary winding up of the company,
- (vi) Alteration of the articles of association,
- (vii) Alteration of the memorandum of association,
- (viii) Initiation of a voluntary resolution plan under IBC;

To ensure effective implementation of such decision, there would be a requirement of amending SEBI Regulations relating to issue of capital (ICDR Regulations), SEBI (Listing Obligation and Disclosure Requirement) Regulations, Takeover Code. It would be interesting to see whether the definition of 'control' under the Takeover Code would be amended and also whether the definition of 'control' under the Companies Act is also amended to that extent. In order to avoid any contradictory provisions with the Companies Act, 2013, there should be a holistic framework under SEBI Regulations for issuance of DVR by a listed company.

Amendments to SEBI (PIT) Regulations

The SEBI Board noted the representations received from the market on certain aspects relating to the Code of Conduct prescribed in SEBI (Prohibition of Insider Trading) Regulations, 2015 ('PIT Regulations'). Based on these representations, the SEBI Board approved amendments clarifying that trading window closure for listed companies shall be applicable from end of every quarter till 48 hours after declaration of financial results. However, such closure shall not be applicable in respect of transactions such as:

- (i) Off-market inter-se transfer between insiders,
- (ii) Transaction through block deal window mechanism between insiders,
- (iii) Transaction due to statutory or regulatory obligations,
- (iv) Exercising of stock options,
- (v) Exercising of pledging of shares for bona fide transaction such as raising of funds and transactions for acquiring shares under further public issue, right issue and preferential issue,
- (vi) Exercising conversion of warrants/debentures,
- (vii) Tendering shares under buy-back, open offer and delisting etc. under respective regulations, subject to conditions specified.

This amendment is in relation to the Minimum Standards for Code of Conduct for Listed Companies to Regulate, Monitor and Report Trading by Designated Persons. Clause 4 of the Schedule B inter-alia stipulates the modalities of opening and closure of trading window to monitor trading by designated persons wherein it is stated that the trading window shall be

closed when the compliance officer determines that a designated person or class of designated persons can reasonably be expected to have possession of unpublished price sensitive information.

Clause 4 of the Schedule B of PIT Regulations was amended (effective from April 1, 2019) to include that trading restriction period can be made applicable from the end of every quarter till 48 hours after the declaration of financial results. NSE by its Circular² had stated that the trading restriction period is required to commence not later than end of every quarter till 48 hours after the declaration of financial results.

The amendments proposed by the SEBI Board creates an exception to SEBI (PIT) Regulations read with NSE Circular w.r.t. the closure of trading window. Therefore, such transactions will be permitted when the trading window is closed (i.e. from end of every quarter till 48 hours after declaration of financial results).

Related Party Transactions w.r.t. payment of relating to royalty and brand usage:

According to the extant provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, the payments by listed company to its related parties towards brand usage or royalty are to be considered material if the transaction(s) exceed 2% of the annual consolidated turnover of the listed entity during a financial year. As such transactions are exceeding the prescribed threshold, the approval of the shareholders is required. Such provision was effective from April 1, 2019. However, based on the representations received from the stakeholders, SEBI deferred the implementation of the said provision for three months i.e. till June 30, 2019.

The SEBI Board has now decided that payments made to related parties towards brand usage or royalty may be considered material if the transaction(s) exceed 5% of the annual consolidated turnover of the listed entity during a financial year and would require approval of the shareholders, with no related party having a vote to approve such resolutions.

The amendment is based on the recommendation of Uday Kotak Committee on Corporate Governance. Probably, there would be many companies for such related party transactions with the limit of 2% of the annual consolidated turnover of the listed entity during a financial year. The effective date of amendment and further amendments to SEBI (Listing Obligations and Disclosure Requirements) Regulations are yet to be notified. The amendment would have an impact on the multi-national companies that are listed on the Indian stock exchanges. Usually, such transactions are with the holding companies. The critical aspect w.r.t. to such approval is when the IPR is held by two more companies (jointly) and such companies are incorporated outside India. Also, the listed company

would be having other transactions (buying, selling of goods and / or services) with such companies.

Definition of 'encumbrances' & its disclosures

The SEBI Board resolved to take certain measures in the context of recent concerns w.r.t. promoter/companies raising funds from Mutual Funds/NBFCs through structured obligations, pledge of shares, non-disposal undertakings, corporate/promoter guarantees and various other complex structures.

The SEBI Board approved the proposal to include the definition of 'encumbrance' in SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, which shall include: (a) Any restriction on the free and marketable title to shares, by whatever name called, whether executed directly or indirectly, (b) Pledge, lien, negative lien, non-disposal undertaking, (c) Any covenant, transaction, condition or arrangement in the nature of encumbrance, by whatever name called, whether executed directly or indirectly.

The SEBI Board has also resolved that the promoters shall be required to disclose separately detailed reasons for encumbrance whenever the combined encumbrance by the promoters and persons acting in concert (PACs) crosses 20% of the total share capital in the company or 50% of their shareholding in the company. The stock exchanges will maintain the details of such encumbrance along with purpose of encumbrance, on their websites. In my view, the nature of disclosures, time-limit shall aligned with the disclosures under SEBI (PIT) Regulations, 2015, the Listing Regulations and the Takeover Code. This may enhance SEBI's monitoring on the trades by promoters and may also reduce litigation in case of non-compliances. Multiple disclosures in different formats with different timelines under 3-4 SEBI Regulations would be a difficult monitoring exercise for SEBI and stock exchanges.

The SEBI Board has also resolved that the promoters shall be required to declare to the audit committee of the company and to the stock exchanges on a yearly basis, that they along with PACs, have not made any encumbrance directly or indirectly, other than already disclosed, during the financial year. Such amendment would require an amendment to the SEBI Listing Regulations and would increase the burden on the independent directors. Accordingly, it may require a yearly declaration to the Audit Committee but in certain cases, the same may be called upon by the Committee on quarterly basis. The role and duty of independent directors will increase in this regard.

Changes in Risk Management Framework of Liquid Funds, Investment Norms, etc.

In light of a few credit events in the fixed income market that led to increase in liquidity risk of Mutual Funds, the SEBI Board felt need to

review the regulatory framework. The amendments have been taken by the SEBI Board to safeguard the interest of investors and maintain the orderliness and robustness of Mutual Funds. Based on the inputs of the working groups (representing AMCs, industry and academia), internal working group within SEBI, the Mutual Fund Advisory Committee has made certain recommendations. Based on several reports, the SEBI Board has approved certain proposals which includes: (i) Liquid Schemes shall be mandated to hold at least 20% in liquid assets such as Cash, Government Securities, T-bills and Repo on Government Securities, (ii) Cap on sectoral limit of 25% shall be reduced to 20%, (iii) Valuation of debt and money market instruments based on mark to market, (iv) Liquid and overnight schemes shall not be permitted to invest in short term deposits, debt and money market instruments having structured obligations or credit enhancements, (v) Graded exit load shall be levied on investors of liquid schemes who exit the scheme upto a period of 7 days, (vi) Mutual Fund schemes shall be mandated to invest only in listed NCDs, (vii) All fresh investments in equity shares by Mutual Fund schemes shall only be made in listed or to be listed equity shares, (viii) Change in the prudential limits on total investment by Mutual Fund scheme in debt and money market instruments having credit enhancements, (ix) There should be adequate security cover of at least 4 times for investment by Mutual Fund schemes in debt securities having credit enhancements backed by equities directly or indirectly.

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1. Press Release No. 16/2019, dated June 27, 2019
 2. NSE Circular No. NSE/CML/2019/11 dated April 2, 2019.