RIGHTS ISSUES – UNTYING THE KNOTS

*Sayantan Dutta**

This Essay unties the knots around the complicated discourse of rights issues in India and proposes some regulatory changes to streamline the process towards ensuring simplicity and equitability. It begins by articulating the concept of a rights issue and examines the practical challenges which arise with regard to renunciation. Apart from renunciation, rights issues also suffer from problems relating to the service of documents to 'Indian' addresses since a company may need to send the letter of offer to non-resident shareholders. Finally, the Essay examines the loopholes which emerge in underwriting a rights issue. The extant mechanism enables the procurement of third-party subscribers through pre-identification which may conflict with the equitable nature of rights issues.

* Partner in the capital markets practice of Shardul Amarchand Mangaldas & Co and based out of its New Delhi office.

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INTRODUCTION

A rights issue of shares is perhaps the most equitable way of raising capital for any company. A rights issue operates as the quintessential mechanism of inviting existing shareholders of a company for more funds on a *pro rata* basis. This is a classic example of a company preserving the pre-emptive rights of the existing shareholders in case of a further issue of capital. The *pro rata* basis perhaps gives it an even more equitable flavor, where every shareholder is invited to invest based on her current shareholding in the company. In an ideal scenario, where every shareholder does subscribe to her entire rights entitlements, the shareholding pattern of the company remains unchanged.

The equitable nature of the rights issue is a probable reason for companies not being mandated to seek the approval of its shareholders in a general meeting. In undertaking a rights issue (the mere approval of the board of directors being adequate), the board of directors is permitted to decide freely on the pricing of the shares being offered in a rights issue (no specific pricing guidelines apply to the same rights issues). While listed companies undertake such a rights issue, the Securities and Exchange Board of India (hereinafter "SEBI") insists on rationalising disclosure requirements.

Rights issues appear to be a win-win situation for both the issuer company and the shareholders. But then like every twist in the tale, comes the complicated character of rights issues – renunciation of rights entitlements, additional subscription, and subscription of the unsubscribed portion in a rights issue. This is where a rights issue becomes a jurisprudential marvel, a transaction structuring tool, and sometimes a regulator's worst headache. In this Essay, the author will attempt to untie the knots around the complicated discourse of rights issues and propose the need for attention from the regulators to streamline the process and make the fundraising through rights issues simple and equitable. This Essay was written in November, 2019, and therefore, does not cover the changes in the rights issue process, which have been made subsequently by the Government of India; particularly, in the aftermath of the COVID-19 pandemic.

I. RIGHTS ISSUE: AS DEFINED UNDER APPLICABLE LAWS

In independent India, the mechanism of rights issue was introduced initially, in a codified way, under the Companies Act, 1956 through Section 81(1),[1] which has now been replaced by Section 62(1)(a) of the Companies Act, 2013. According to Section 62(1)(a) of the Companies Act, 2013,[2] a rights issue is an offer:

- "*made by notice specifying the number of shares offered and limiting a time not being less than fifteen days and not exceeding thirty days from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;*
- *Unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice referred above shall contain a statement of this right;*
- *After the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the board of directors may dispose of them in such manner which is not disadvantageous to the shareholders and the company.*"

[1] The Companies Act, 1956, No. 01, Acts of Parliament, 1956.
[2] The Companies Act, 2013, No. 18, Acts of Parliament, 2013.

Rights issues can be undertaken by both listed and unlisted companies, and some of the challenges are common to both. For the purpose of this Essay, the focus will be limited to rights issues by listed companies, where the stakes are higher, the strategies are sharper, and the regulations are stricter.

Rights issues by listed companies are primarily governed by the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018[3] (hereinafter "SEBI (ICDR) Regulations, 2018"), the comparatively newer regulations from the stable of the SEBI, replacing the old Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.[4] According to the SEBI (ICDR) Regulations, 2018, a rights issue is "*an offer of specified securities by a listed issuer to the shareholders of the issuer as on the record date fixed for the said purpose.*"[5]

II. RENUNCIATION: A STATUTORY RIGHT BUT A REGULATORY CHALLENGE

The Companies Act, 2013 provides for a right of renunciation to the shareholders of a company in a rights issue.[6] An existing shareholder can transfer her rights entitlement to another person, whether or not she is an existing shareholder of the company.

The *first* challenge concerning the right of renunciation involves non-resident investors. The Foreign Exchange Management Act Regulations (hereinafter "FEMA Regulations") govern the transfer of shares or securities between resident and non-resident investors.[7] However, there is no specific provision regulating the transfer of rights entitlements between them. It should be noted that this is not a transfer of shares but a transfer of a right to subscribe to shares.

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[3] The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, SECURITIES AND EXCHANGE BOARD OF INDIA, https://www.sebi.gov.in/legal/regulations/sep-2018/securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-regulations-2018-_40328.html (last visited October 18, 2019).

[4] The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, SECURITIES AND EXCHANGE BOARD OF INDIA, https://www.sebi.gov.in/acts/icdrreg09.pdf (last visited October 18, 2019).

[5] The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, Regulation 2(1)(xx), *supra* note 5.

[6] The Companies Act, 2013, §62(1)(a)(ii).

[7] The Foreign Exchange Management (Non-debt Instruments) Rules, 2019, THE GAZETTE OF INDIA (2019), http://egazette.nic.in/WriteReadData/2019/213332.pdf (last visited October 18, 2019).

Historically, Indian companies used to seek prior approval from the Reserve Bank of India (hereinafter "RBI") for such a transfer of rights entitlements between resident and non-resident investors in a rights issue. A closer study of the rights issues undertaken by listed companies in India reveals that the RBI has granted such approval to companies from time to time. However, there has generally been a pre-condition included in such approval by the RBI to the renunciation between resident and non-resident investors.[8] Such a pre-condition allows renunciation only on the floor of stock exchanges and not through private arrangements.[9] Since there is no specific pricing guideline available for the transfer of rights entitlements (which is not a transfer of shares) between resident and non-resident investors, the RBI has intended to mark such transfer of rights entitlements to a market or trading price. This had been done to ensure there is no zero-consideration renunciation involving non-resident investors.

It is interesting to note that when the RBI introduced the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017[10] (hereinafter "FEMA 20"), it added the following explanation at the end of Regulation 6: "*The above conditions shall also be applicable in case a person resident outside India makes investment in capital instruments (other than share warrants) issued by an Indian company as a rights issue that are renounced by the person to whom it was offered.*"[11] Subsequently, the FEMA 20 was replaced by the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (hereinafter "FEMA (Non-Debt Instruments) Rules").[12] The new FEMA (Non-Debt Instruments) Rules carried the same explanation under Rule 7. Such an added explanation would ideally mean that the subscription of shares in a rights issue through renunciation involving non-resident investors are exempted from the pricing guidelines under the FEMA (Non-Debt Instruments) Rules. Hence, companies would no longer require such approval from the RBI for renunciation involving non-resident investors.

However, based on what has transpired, either the RBI has not taken note of the afore mentioned addition of the explanation to the FEMA 20, or it has intentionally ignored the FEMA (Non-Debt Instruments) Rules in recent rights issue transactions. For example, in the recently

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[8] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017, Regulation 6, https://www.rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=11161 (last visited October 18, 2019).
[9] Sayantan Dutta, *HR Khan Committee Report: Revamping the FPI Regime in India,* Bloomberg Quint (Jan. 23, 2020), https://www.bloombergquint.com/opinion/hr-khan-committee-report-revamping-the-fpi-regime-in-india (last visited May 18, 2020).
[10] *Supra* note 8.
[11] *Id.*, Regulation 6.
[12] The Foreign Exchange Management (Non-debt Instruments) Rules, 2019, *supra* note 7.

concluded rights issue by Vodafone Idea Limited in March 2019,[13] a prior clarification was obtained from the RBI, whereby renunciation involving non-resident investors was limited to renunciation on the floor of stock exchanges.[14] If the intention is to permit renunciation involving only non-resident investors on the floor of the stock exchanges, the RBI should bring an amendment to the FEMA (Non-Debt Instruments) Rules, and the explanation should be further 'explained' to provide for such regulatory intention. In the absence of such a detailed explanation and the presence of such intentional regulatory supervision, the issuer companies and the investors remain unsure about the mechanism to be followed for undertaking a rights issue.

Further, pursuant to its recent circular dated January 22, 2020, the SEBI has made a few changes in the rights issue process. One of the changes is a mandatory dematerialisation of the rights entitlements and the trading of such dematerialised rights entitlements on the stock exchanges with a T+2 rolling settlement timeline.[15] Both, the SEBI and RBI need to provide more coordinated guidance to the investors, issuers, and intermediaries regarding the renunciation mechanism through collectively making cohesive amendments. Additionally, by mandating the trading of rights entitlements on the floor of the stock exchanges and excluding renunciation through private arrangements by non-resident investors, the SEBI and RBI have ended up prohibiting investors of foreign direct investment (hereinafter "FDI") from renouncing their rights entitlements. This is otherwise available to them as a statutory right under the Companies Act, as FDI investors cannot trade on the stock exchanges at all.[16]

The *second* challenge relates to renunciation to non-shareholder investors. Renunciation under the Companies Act is not prohibitive, and a shareholder is entitled to renounce her rights entitlement to any person in full or in part. The renouncee need not be an existing shareholder of the company to accept the rights entitlement. While this is a convenient mechanism to both the shareholder, who does not want to subscribe to her rights entitlement as well as the issuer company, who is still able to raise capital by allotting the shares to the renouncee, this does extend the

[13] Letter of Offer dated March 22, 2019 of Vodafone Idea Limited, shorturl.at/kOPQX (last visited October 18, 2019).
[14] Letter of Offer dated March 22, 2019 of Vodafone Idea Limited, pg. 844, shorturl.at/AEHU2 (last visited October 19, 2019).
[15] SEBI Circular (SEBI/HO/CFD/CMD/CIR/P/2020/12) dated January 22, 2020, https://www.sebi.gov.in/legal/circulars/jan-2020/streamlining-the-process-of-rights-issue_45753.html (last visited February 27, 2020).
[16] Only foreign portfolio investors can trade on the stock exchanges.

comforts and luxuries of the rights issue to a third-party investor, who is not a shareholder of the company as on the record date.

This also opens doors to potential exploitation of the rights issue route to allot shares to pre-identified third-party investors at a price which is not dictated by any pricing guideline, and without any prior approval of the shareholders of the company. The SEBI (ICDR) Regulations, 2018 provide for specific pricing guidelines for different kinds of issuances of securities. For example, initial public offerings (hereinafter "IPO") and follow-on public offerings follow a book-building mechanism to discover the final price,[17] whereas qualified institutional placements and preferential allotment mechanisms also have a weekly average pricing formula with specific periods for determining the minimum floor price.[18]

However, rights issues in comparison are freely priced – it can be priced above or below the trading price of the shares, as long as such pricing is not below the face value of the shares. It is not uncommon for companies to structure their fund-raising transactions through a rights issue to provide an entry to certain pre-identified third-party investors at a price of their choice. This issue was also discussed in the Report of the Companies Law Committee of February 2016.[19] However, no concrete solutions were proposed in the 2016 Companies Law Committee Report. One of the steps that can be considered to negate this exploitation of the pricing advantage by promoters or large investors, is to keep a cap on the size of renunciation to third-party investors. However, that can also be bypassed by a third-party investor by purchasing a few shares prior to the record date and becoming a shareholder of the company at the time of renunciation.

Another interesting proposal was recently made by the SEBI constituted working committee under the chairmanship of HR Khan, retired deputy governor, RBI, in 2019. The Khan Committee was entrusted with the task of reviewing the erstwhile Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014, and paved the way for the new Securities and

[17] The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, Regulation 28(2) and Regulation 126(2), *supra* note 7.
[18] The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, Regulation 164 and Regulation 176, *supra* note 7.
[19] TAPAN RAY ET AL., REPORT OF THE COMPANIES LAW COMMITTEE, 2016, MINISTRY OF CORPORATE AFFAIRS, https://www.mca.gov.in/Ministry/pdf/Report_Companies_Law_Committee_01022016.pdf (last visited October 14, 2019).

Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019.[20] The Khan Committee had recommended that the transfer of rights entitlements involving foreign portfolio investors in rights issues shall be at the ruling market price in case of a transfer on the floor of the stock exchange or at the fair market value in case of a transfer through private arrangement.[21]

Thankfully, this was not implemented, as this would have meant another implementation nightmare since valuations for rights entitlements (and not of shares) would be a very difficult task given the free pricing adopted for the final subscription of the shares being offered in a rights issue. A fair valuation method (primarily used for unlisted shares) or a market based average trading price (used for listed shares) would be difficult to apply in case of rights entitlements. This is because rights entitlements are neither 'securities' nor do they have a steady trading history because rights entitlements are traded only for those 15 days, during which a rights issue is open.

Accordingly, the proposal that can be mooted to remedy this loophole is a cap on the discount that a company can provide on the trading price of the shares while deciding the final price of the shares being offered in a rights issue by listed companies. If such a cap on the discount is not to be applied to the pricing of the shares in the rights issues, a restriction on the renunciation of rights entitlement may be applied to the promoter and promoter group shareholders of the company. These two options will be available on an either-or basis to the issuer companies. While the introduction of a pricing formula in a rights issue is perhaps a conservative step, having only a one-way cap either on the discount or on the renunciation by the promoter and the promoter group shareholders may not be excessively restrictive. This is due to the presence of a similar restriction in the form of compulsory subscription of the entire rights entitlements by the promoters and the promoter group shareholders as a pre-condition for at least fast-track rights issues.

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[20] Securities and Exchange Board (Foreign Portfolio Investors) Regulations, 2019, THE GAZETTE OF INDIA (2019), https://www.sebi.gov.in/legal/regulations/dec-2019/securities-and-exchange-board-of-india-foreign-portfolio-investors-regulations-2019-last-amended-on-december-19-2019-_44436.html (last visited October 10, 2019).
[21] HARUN R. KHAN ET AL., REPORT OF THE WORKING GROUP ON FPI REGULATIONS (2019), https://www.sebi.gov.in/sebi_data/commondocs/may-2019/Annexure-A_p.pdf (last visited October 9, 2019).

III. SERVICE OF DOCUMENTS TO 'INDIAN' ADDRESSES: THE MULTI-JURISDICTION ISSUES REGARDING SOLICITATION AND REGISTRATION

Under section 53(1) of the Companies Act, 1956, a company could serve a document to its shareholders to the Indian addresses provided by such shareholders.[22] However, this has since been done away within the Companies Act, 2013. The Companies Act, 2013 has omitted any such provision, which requires a company to serve any document only to the Indian addresses of its shareholders.[23] This creates difficulties for companies undertaking rights issues, where a company has non-resident shareholders.

Sending a letter of offer or similar documentation concerning a rights issue to jurisdictions outside India may violate the solicitation of investment rules of that jurisdiction. Consequently, this may trigger registration requirements along with other compliance and disclosure requirements under the securities laws of such overseas jurisdictions. It may impact the process of ensuring the participation of the shareholders in the rights issue of shares. Further, the act of not sending the letter of offer to any non-resident shareholder (who does not have an Indian address) may not be in complete compliance with the rights issue requirements under the Companies Act, 2013.

It is accordingly proposed that a suitable clarification be included preferably in Rule 35 of the Companies (Incorporation) Rules, 2014. Such clarification should hold that in case of non-resident shareholders, it would be adequate compliance if the company were to serve the documents to the Indian address, if any, of such shareholder, in case of a rights issue, and also make the provision of Indian addresses mandatory for all shareholders.[24]

IV. UNDERWRITING A RIGHTS ISSUE

The SEBI (ICDR) Regulations, 2018 specify that the minimum subscription to be received in a rights issue has to be at least 90% of the offer made through the letter of offer.[25] In the event of a non-receipt of a minimum subscription of 90% of the total offer, the rights issue will fail and all

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[22] The Companies Act, 1956, *supra* note 1.

[23] The Companies Act, 2013, *supra* note 2.

[24] The Companies (Incorporation) Rules, 2014, Rule 35, https://www.mca.gov.in/Ministry/pdf/NCARules_Chapter2.pdf (last visited October 18, 2019).

[25] The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, Regulation 86(i), *supra* note 7.

the application monies will have to be refunded to the investors. This provision is similar to the minimum subscription provision applicable to an IPO.[26]

Historically, there have been two kinds of back-stopping or underwriting in rights issues: (i) promoters specifically undertaking to subscribe to the unsubscribed portion of a rights issue; and (ii) the SEBI registered underwriters underwriting the unsubscribed portion of a rights issue. Underwriting in rights issues in India has typically been in the nature of hard underwriting, where the underwriters undertake to subscribe to the unsubscribed portion even before the opening of the rights issue. This is in contrast to the soft underwriting approach taken in the IPOs, where the underwriting agreement is signed only after the closure of the issue and the risks of the underwriters are mitigated to a great extent.

Undertaking from the promoters to subscribe to the unsubscribed portions has been a popular method given the various advantages attached to it. Such an undertaking from the promoters boosts the morale of the investors. From the perspective of the promoters, this is a great opportunity to consolidate their shareholding in the company at a discounted price, if the promoters possess the means to subscribe to the unsubscribed portion. The erstwhile Securities and Exchange Board of India (Substantial Acquisitions of Shares and Takeover) Regulations, 1997 provided for a specific exemption from open offer requirements for such an additional subscription by promoters (or persons in control).[27] However, the current Securities and Exchange Board of India (Substantial Acquisitions of Shares and Takeover) Regulations, 2011 exempt only persons holding at least 25% of the total share capital of the company from such open offer requirements while agreeing to subscribe to the unsubscribed portion in a rights issue.[28]

This was a welcome change as the mantle to back-stop in a rights issue should be limited to large shareholders of the company – preferably promoters or shareholders holding at least 25% of the total share capital of the company. This excludes back-stopping of a rights issue by third party

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[26] The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, Regulation 45(i), *supra* note 7.

[27] Securities and Exchange Board of India (Substantial Acquisitions of Shares and Takeover) Regulations, 1997, Proviso to Regulation 3(1)(b), https://dipam.gov.in/sites/default/files/act15a_0.pdf (last visited October 11, 2019).

[28] Securities and Exchange Board of India (Substantial Acquisitions of Shares and Takeover) Regulations, 2011, Proviso to Regulation 10(4), https://www.sebi.gov.in/legal/regulations/apr-2019/securities-and-exchange-board-of-india-substantial-acquisition-of-shares-and-takeovers-regulations-2011-last-amended-on-july-29-2019-_40714.html (last visited October 18, 2019).

investors without triggering an open offer if the creeping acquisition limits are breached due to their subscription of the unsubscribed portion because of their back-stopping obligations.

Rights issues can be underwritten by the SEBI registered underwriters as well by signing an underwriting agreement with the issuer company. However, underwriting in rights issues is not devoid of its share of legal complications. The SEBI has for a long time proposed a model underwriting agreement as an indicative arrangement between the issuer companies and the underwriters. While the underwriting agreements are heavily negotiated between the issuer company and the underwriters for representations, warranties, and indemnity clauses; the general underwriting mechanism is standard across all rights issue transactions and is not very far from the model underwriting agreement. It would be interesting to note the following paragraph from the SEBI Model Underwriting Agreement:

> "*We hereby record that we (hereinafter referred to as the underwriter) have agreed to underwrite/procure subscription to shares/debentures of Rs...... each for cash at par/premium aggregating to Rs..... (Rupees.... only) (hereinafter referred to as the underwriting obligation) for the captioned public issue by.... Ltd. (hereinafter referred to as "the Company" on the following terms and conditions.*"[29]

The SEBI Model Underwriting Agreement provides for the subscription of the unsubscribed shares by the underwriters or procurement of subscribers, who will subscribe to the unsubscribed shares by the underwriters.[30] This would mean that if the underwriter itself does not want to subscribe to the unsubscribed shares, it can procure a third-party subscriber to subscribe to the unsubscribed shares in the rights issue. If such procurement of subscribers is allowed in the case of rights issues, it can again defeat the purpose of the equitable nature of a rights issue.

This possibility arises as one can pre-identify a third party investor. Instead of allotting shares to such a third party investor through the preferential allotment mechanism (and adhering to the pricing guidelines of a preferential allotment), one may allot shares to such a third party investor as a procured subscriber by the underwriter through the underwriting mechanism prescribed in the underwriting agreement for a rights issue. Such a scenario may also extend the pricing advantage typical in a rights issue to such a pre-identified third party investor. Moreover, this does not trigger any open offer requirements since the acquisition of shares through underwriting or subscription to

[29] SEBI Circular RUW Circular No. 1 (1993).
[30] *Id.*

the unsubscribed portion of an issue by a SEBI registered underwriter or a nominated investor as per the SEBI (ICDR) Regulations, 2018 is exempt from the open offer requirements under the Securities and Exchange Board of India (Substantial Acquisitions of Shares and Takeover) Regulations, 2011.

Underwriting is a safety net arrangement that the issuers should be allowed to avail in capital markets offerings because, without such a safety net, the issuers may be increasingly wary of accessing the capital markets which does not augur well for any economy. However, at the same time, there have to be checks and balances to ensure that the procurement mechanism in the underwriting process does not become a backdoor entry for pre-identified third-party investors.

For this purpose, the SEBI can make it mandatory to execute procurement agreements between the underwriters and the procured subscribers. It can mandate that such procurement agreements be simultaneously executed when the underwriting agreement is executed and full disclosures of such procurement arrangements have been made in the letter of offer. This will make the procurement process more transparent, and investors will have all the information about the back-stopping arrangements made for the rights issue prior to making any investment. It may also happen that such upfront disclosure of procurement arrangements may boost the confidence of the general investors in the rights issues.

CONCLUSION

Rights issues continue to be the quintessential mechanism of raising capital by issuing equity shares to the existing equity shareholders through a *pro rata* basis. The rights issue mechanism must be streamlined, well-constructed, and more standard in its process, application, and disclosure norms. Recently, there have been several steps taken by the SEBI including the mandatory dematerialisation of the rights entitlements with a T+2 rolling settlement of the traded rights entitlements and the reduction of time in the overall rights issue process by decreasing the number of days at various stages.[31]

[31] SEBI Circular (SEBI/HO/CFD/CMD/CIR/P/2020/12) dated January 22, 2020, https://www.sebi.gov.in/legal/circulars/jan-2020/streamlining-the-process-of-rights-issue_45753.html (last visited February 24, 2020).

However, more efforts need to be made not only towards making the rights issue process faster and efficient but also towards unravelling the complicated jurisprudence of rights issues and keeping it free from potential exploitation by investors and issuers. After all, a rights issue is an exercise of the typical right of first refusal, or in other words, a right of first refusal by each shareholder of a company. How can we let such a spectacularly equitable route of capital raising down in the current Indian capital markets scenario?