

Corpsec Hotline

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ANOTHER STEP FORWARD BY INDIA INC : DVR SHARES

- Issuance of shares with differential voting rights by tech companies to their promoters, now permitted.
- Promoters must hold an executive position in the company and the maximum voting rights is limited to 10:1.
- Total voting rights of shareholders holding shares with differential voting rights limited to 74%.
- Post listing, in case of decisions relating to certain matters, the holders of shares with differential voting will have rights akin to those of ordinary shares.
- Sunset period for conversion into ordinary shares.

BACKGROUND

Shares with differential voting rights ("DVRs") are those which have rights attached to them that are disproportionate to the economic rights over the shares. Shares with DVRs can either have superior voting rights (i.e. multiple votes on one share) or inferior voting rights (i.e. a fraction of the voting right on one equity share) or differential rights as to dividend. Shares with DVRs which have been more popular in the western world, have been gaining momentum in India in the recent past.

Way back in 2000, the Companies Act, 1956¹ was amended to permit issuance of shares with DVRs. However, in 2009, the Securities & Exchange Board of India ("SEBI") amended the equity listing agreement to prohibit listed companies from issuing shares with superior rights as to voting or dividend vis-a-vis the rights on equity shares that are already listed.² This position was re-iterated in the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("LODR Regulations").³ Now, the Companies Act, 2013 also provides for issuance of equity shares with differential voting rights albeit with certain conditions.⁴

Promoters of a company may not always be able to meet the company's growing funding demands and in such cases, companies and promoters seek investment from external sources including from institutional investors. External rounds of financing not only lead to dilution of the promoters' shareholding in the company, but also result in key business decisions being made by investors who have brought in more capital in the company. In such a scenario, shares with DVRs help promoters in retaining their right to vote on business decisions irrespective of their capital contribution.

REGULATIONS FOR ISSUANCE OF DVRs

SEBI at its board meeting held on June 27, 2019 proposed a framework ("DVR Framework") for issuance of DVRs⁵ based on the consultation paper which had been circulated for public comments in March 2019 ("Consultation Paper")⁶. In the Consultation Paper, SEBI had categorically stated that DVRs with superior voting rights if issued to promoters in promoter led companies will help such promoters in retaining decision-making powers and rights vis-a-vis other shareholders. In light of the aforesaid framework, SEBI amended the LODR Regulations, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2013 ("ICDR Regulations"), the SEBI (Buy-back of Securities) Regulations, 2018, SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("Takeover Regulations") and the SEBI (Delisting of Equity Shares) Regulations, 2009 (collectively "Regulations") with effect from July 29, 2019.

The DVR Framework and the consequent amendments to the Regulations have brought about much needed optimism amongst promoters. In the more recent and much publicized instance of the hostile takeover of Mindtree Limited by Larsen and Toubro Ltd., in which the promoters of Mindtree were unable to thwart the takeover bid by Larsen and Toubro which eventually led to their resignation, had only augmented the demand for issuance of shares with superior voting rights amongst promoters in India.

Key Features of the law in relation to DVRs

Eligibility

Subject to fulfilment of all other requirements under the ICDR Regulations, a company which has issued shares with superior voting rights ("DVR Shares") to its promoters would be permitted to list its shares only if the following conditions are met:

- The company should be a tech company i.e. intensive in the use of technology, information technology, intellectual property, data analytics, bio-technology or nano-technology, to provide products, services or business platforms with substantial value addition;
- The promoter group to whom the DVR Shares are issued can have a collective net worth of not more than INR 5000 million. The investment of this promoter group in the shares of the company listing its shares will not be

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- considered for calculating the collective net worth;
- iii. The DVR Shares must be issued only to promoters who hold an executive position in the company;
 - iv. The issue of DVR Shares must be authorized by a special resolution of the shareholders of the company. The notice for the shareholders meeting must specify *inter alia*, the ratio of voting rights, sunset provisions etc.;
 - v. The DVR Shares should have been held for at least 6 months prior to the filing of the red herring prospectus;
 - vi. These DVR Shares can have voting rights in the ratio of a minimum of 2:1 to a maximum of 10:1 (i.e. 10 votes for every share).
 - vii. The DVR Shares must have the same face value as ordinary shares and there should be only one class of DVR Shares in a company.

Analysis:

- While DVR Shares can be issued by asset light companies such as tech companies, the Regulations have certainly left outside their ambit, several companies engaged in various other businesses which may not necessarily be intensive in the use of information technology.
- SEBI also seems to have not laid down a test to determine as to what would constitute as intensive use of technology.
- Since there is a restriction on issuing DVR Shares only to promoters acting in their executive capacity, promoter held and controlled entities holding shares in the issuing company may not be eligible to subscribe to DVRs.
- In addition, SEBI has laid down a requirement of a special resolution for issue of DVRs when the Companies Act, 2013 requires only an ordinary resolution for issuance of shares with DVRs.

Rights on the DVR Shares

While the DVR Shares are treated at par with ordinary equity shares in every respect including dividends (except for voting), the total voting rights of shareholders holding DVR Shares (including their ordinary shares) should not exceed 74%. Further, post listing, a listed entity continues to not be allowed to issue shares that confer on any person superior or inferior rights as to dividend vis-a-vis the rights on already listed equity shares or inferior voting rights vis-a-vis the rights on equity shares that are already listed. However, bonus or rights issuances may be made on the DVR Shares which shall have the same rights as that of the existing DVR Shares. A shareholder holding DVR Shares is also not allowed to renounce the shares in favour of any other person, in case of a rights issue.

Post an initial public offering, however, the DVR Shares will be treated as ordinary shares in terms of voting for items such as transfer of control in the company willingly by the promoter, related party transactions, amendments to the charter documents of the company, other than amendments affecting the DVR Shares.

Analysis:

- Limiting the voting rights of DVR Shares to 74% should be able to ensure that the holders of DVR Shares are not able to pass a special resolution unilaterally.
- Several items being kept out of the purview of the superior voting rights of the holders of the DVR Shares is likely to ensure that the interests of other shareholders are not adversely affected.
- However, it is likely that the above restriction may make DVRs less attractive among companies / promoters as voting on several important items are excluded from their superior voting rights.
- Issuance of shares with fractional or lower voting rights is not permitted post listing.

Conversion of DVR Shares, Lock-in, Other Restrictions

While the DVR Shares can be listed on stock exchanges, they shall be locked-in after the initial public offering, until the later of (i) their conversion to ordinary shares or (ii) 3 years from the date of commencement of commercial production⁷ or date of allotment in the initial public offer, whichever is later.

The DVR Shares are neither allowed to be transferred inter-se amongst promoters nor is any pledge / lien allowed to be created on these shares.

The DVR Shares can be converted into ordinary equity shares in the following situations:

- i. **Time based:** On the 5th anniversary of listing, however, this period may be extended by another 5 years through a resolution, in which resolution the holder of such DVR Shares is not allowed to participate. The LODR Regulations does not seem to provide clarity as to whether a special or ordinary resolution is required for such extension.
- ii. **Event based:** Upon the demise, resignation of the holder of the DVR Shares or upon consummation of a merger or acquisition whereby the holder of the DVR Shares would no longer have control over such shares.

Analysis:

- Since promoter shares are usually encumbered for loans availed by companies, the restriction on creating encumbrances on DVR Shares may make raising of capital from banks/ financial institutions difficult for promoters.
- Promoters will also not be able to convert the DVR Shares into ordinary shares unless the sunset period has expired. This may help in ensuring that the promoters are effectively involved in managing the affairs of the company in their executive position at least for a period of 5 years from listing.
- Since the DVR Shares will convert into ordinary shares upon the demise, resignation of the holder, the shares that devolve upon the successors of the promoters would end up being ordinary shares.

The LODR Regulations has also been amended to impose additional corporate governance requirements on companies which have issued DVR Shares, being that independent directors should comprise of at least 5 of the board of directors and 2/3rd of the committees of the board (excluding the audit committee which should comprise fully of independent directors).

The Takeover Regulations has been amended to exempt any increase in voting rights of a shareholder beyond the

25% threshold, if such increase in voting rights is as a result of conversion of the DVR Shares into equity shares without the acquisition of control from the requirement of an open offer.

DVRS ACROSS THE WORLD⁸

Internationally many countries such as the United States of America, Canada, Hong Kong, Singapore etc. allow issuance or listing of Dual Class Shares ("DCS") which are similar to DVRs. Countries such as United Kingdom, Australia, Spain, Germany and China do not permit DCS to be listed. The DCS issued in these countries can either have superior voting rights or other economic rights such as dividend. 700 public companies in the United States of America including listed ones like Google, Facebook, Snapchat and Alibaba have issued DCS. SEBI seems to have sought features for issuance and listing of DCS from across jurisdictions to permit the issue of DVRs in India. While the United States of America does not permit entities, which are once listed to implement the DCS structure, there is no requirement to have a sunset period i.e. a period within which the DCS will be converted into ordinary shares. In Hong Kong, only innovative issuers / biotech companies are permitted to issue DCS and the beneficiaries of these shares should play an active executive role in the business, should have contributed materially to the growth of the business and should be a director on the board at the time of the initial public offering. Further, the maximum voting rights per share is not allowed to exceed 10 times the voting rights on ordinary shares and if the beneficiaries of such shares die, cease to be a director or transfer their shares, the rights attached to the DCS will lapse. Singapore also has similar conditions like Hong Kong on maximum voting rights and lapse of such rights. The DCS issued in Singapore are also locked in for a period of 12 months post listing.

DVRS IN INDIA

Tata Motors was one of the first companies in India to issue DVRs in 2008. These DVRs carried 1/10th voting rights and 5% higher dividend than ordinary shares. Since then, Pantaloon Retails (currently Future Enterprises Ltd.), Gujarat NRE Coke Ltd., Jain Irrigation Systems Ltd. have all issued DVRs. Since SEBI did not allow shares with superior voting rights to be listed, the shares issued by these companies have inferior voting rights. Though the Consultation Paper had discussed the issuance of shares with fractional or lower voting rights, SEBI has disallowed the issuance of shares with inferior voting rights by existing listed companies. In the DVR Framework, SEBI had provided for review of issue of shares with inferior voting rights after gaining experience with DVR Shares. There is no clarity on how the shares with inferior voting rights already issued by these companies will be treated. A company which has issued DVR Shares to its promoters, may issue such shares through a bonus, split or rights issue. Currently, issuance of DVR Shares is permitted only by unlisted companies which was also laid down by SEBI in the Consultation Paper. While SEBI has not laid down the reason for not permitting an existing listed company from issuing DVR Shares, it seems unfair that an existing listed company cannot issue such shares even if the same is approved by way of a special resolution of its shareholders.

Along with the amendments proposed by SEBI, the Ministry of Corporate Affairs has also amended the Companies Act, 2013 and the rules thereunder in relation to issuance of DVR Shares. One of the conditions under the Companies Act, 2013 for issuance of DVR Shares was that only companies (unless the articles of private companies provide otherwise) that have consistent track record of distributable profits for 3 years are eligible to issue DVR Shares and such DVRs cannot constitute more than 26% of the share capital of the company. Since it is challenging for a company to consistently achieve profits for 3 years and when companies are largely valued for their ability and future potential, this condition had made it highly impossible for any company to issue DVRs. Now the profitability requirement has been done away with and instead of limiting the DVR Shares based on the total share capital, the Companies Act, 2013 similar to the Regulations provides that the voting power in respect of DVR Shares should not exceed 74% of the total voting power in the company.

DVRs when issued will have far reaching consequences for promoters, will be completely dependent on how well promoters can convince investors to invest / remain invested in a company in which they have superior voting rights. Investors will have to be persuaded with higher dividends and of course the unwritten promise that the promoters will continue to be involved in managing the affairs of the company in an executive position.

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You can direct your queries or comments to the authors

¹By way of amendment to Section 86 of the Companies Act, 1956 and omission of Section 88

² Circular No. EBI/CFD/DIL/LA/2/2009/21/7, Amendments to Equity Listing Agreement, July 21, 2009 available at https://www.sebi.gov.in/legal/circulars/jul-2009/amendments-to-the-equity-listing-agreement_4367.html

³ Section 41(3) of the Companies Act, 2013

⁴ Section 43 of the Companies Act, 2013 and Rule 4 of the Companies (Share Capital and Debentures) Rules, 2016

⁵ Press release available at https://www.sebi.gov.in/media/press-releases/jun-2019/sebi-board-meeting_43417.html

⁶ Available at https://www.sebi.gov.in/reports/reports/mar-2019/consultation-paper-on-issuance-of-shares-with-differential-voting-rights_42432.html

⁷ Date of commencement of commercial production means the last date of the month in which commercial production of the project in respect of which funds are proposed to be utilized as stated in the offer document, is expected to commence.

⁸ Consultation Paper, available at https://www.sebi.gov.in/reports/reports/mar-2019/consultation-paper-on-issuance-of-shares-with-differential-voting-rights_42432.html

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