Corpsec Hotline

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SEBI TWEAKS THE REGULATORY FRAMEWORK FOR INITIAL PUBLIC OFFERINGS

BACKGROUND

In order to address some of the issues stemming from the recent spate of initial public offerings ("**IPO**") in India, the Securities and Exchange Board of India ("**SEBI**")[1] recently introduced certain amendments to the existing regulatory framework for IPOs pursuant to which the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Amendment) Regulations, 2022[2] ("**ICDR Amendment Regulations**") have been notified with effect from January 14, 2022. We have provided a summary of the key amendments introduced by SEBI along with our analysis below.

KEY AMENDMENTS

1. **Conditions for objects of the issue**

   Position under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ("ICDR Regulations"): Under Regulation 2(1)(r) read with Regulation 7(2) of the ICDR Regulations, issuer companies are permitted to specify upto 25% of the fresh issue size to general corporate purposes, which includes specified purposes for which no specific amount is allocated or any amount so specified towards general corporate purpose or such other purpose, by whatever name called in the offer document.

   Position under the ICDR Amendment Regulations: Under the ICDR Amendment Regulations, limits for issuer companies have not only been altered in relation to utilization of IPO proceeds for unidentified inorganic acquisitions or strategic investments ("**Future Inorganic Growth**") but also for general corporate purposes. The changes are as follows:

   i. the amounts raised by the issuer company for Future Inorganic Growth and general corporate purposes together shall not exceed 35% of the total amount raised

   ii. the amount raised by the issuer company earmarked for Future Inorganic Growth shall not exceed 25% of the total amount raised

   iii. no caps will be applicable on the amounts raised if the acquisition or investment target has been disclosed or identified in the draft red herring prospectus ("**DRHP**") or the red herring prospectus ("**RHP**") filed by the issuer company with SEBI

   The aforesaid amendments seem attributable to some of the recent IPOs where funds were raised without identifying the specific acquisitions or investment targets. The draft offer documents filed in this regard specified objects of fund raise to be *Funding of Inorganic Growth Initiatives*, which include acquisitions/ investments in business initiatives and strategic partnerships without identifying the target acquisition or specific investment.

   While the amendment is aimed at upholding the interests of the public investors at large and bridging the information asymmetry between the issuer company and investors regarding the deployment of investor funds, it is likely to curb the flexibility of the issuer companies, particularly the new age technology companies, which are (i) asset light and do not require funds for capex/ investments in fixed assets as is the case with most traditional businesses; (ii) identifying acquisitions or the right investment targets at such an early stage of fund-raising may be difficult and they prefer making opportunistic acquisitions over time due to the constant disruption in the market.

   Having said that, the balance of interest between the issuer company and the investors, was required to be drawn owing to the risk associated with earmarking a large portion of fresh issue size to such unidentified acquisitions/ investments.

2. **Monitoring of utilization of IPO proceeds**

   Position under the ICDR Regulations: Regulation 41 requires issuer companies to appoint a monitoring agency to monitor and prepare reports on utilisation of issue proceeds. However, the monitoring requirement extended only to 95% of the proceeds and excluded from its purview, the proceeds raised for general corporate purposes.

   Position under the ICDR Amendment Regulations: The following changes are made in relation to monitoring of utilization of IPO proceeds:

   i. only SEBI registered credit rating agencies are permitted to act as monitoring agencies instead of scheduled commercial banks and public financial institutions

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ii. monitoring of the funds raised by the issuer companies must be done for the entire proceeds instead of the erstwhile requirement of 95% of the amounts raised
iii. utilization of funds raised for general corporate purposes must be monitored and subsequently disclosed in the monitoring agency report
iv. monitoring agency report will be placed for consideration before the issuer company's audit committee every quarter instead of on an annual basis (as required earlier)

Given that the allocation of issue proceeds for general corporate purpose is a function of the issue size, the larger the issue size, the larger the 25% pool for general corporate purpose, SEBI felt the need to put a monitoring mechanism in place to oversee the utilization of funds by the issuer companies. The amendments may preclude issuer companies from diverting the IPO funds for purposes other than those stated in the offer documents.

3. **Lock in Period: IPOs and Preferential Allotment**

A. Lock in period for Anchor Investors

Position under the ICDR Regulations: Under Regulation 288(4) of the ICDR Regulations, shares allotted to Anchor Investors[3], are locked in for a period of 30 (thirty) days from the date of allotment.

Position under the ICDR Amendment Regulations: The existing lock in of 30 (thirty) days has been extended to 90 (ninety) days for 50% of the portion allocated to Anchor Investors. This amendment shall apply to all IPOs opening on or after April 1, 2022.

The rationale behind introducing a lock in for anchor investors was to boost investor confidence in the issue. Keeping in view that an increased lock in will only further strengthen the investor confidence, two options that seemed viable were whether to have an extended lock in for all the Anchor Investors or make the lock in applicable to a certain percentage of the anchor investor pool. Given the latter accords more flexibility to Anchor Investors while retaining the spirit of the amendment, SEBI decided to extend the lock in to 50% of the stake of the Anchor Investors.

B. Lock-in period for AIFs, VCFs and FVCIs

Position under the ICDR Regulations: Under Regulation 17 of the ICDR Regulations, the entire pre-issue share capital of the issuer company (other than the promoters) shall be locked in for a period of 1 (one) year from the date of allotment in the IPO except for equity shares issued to Category I and Category II Alternative Investment Funds ("**AIFs**"), venture capital funds ("**VCFs**")and foreign venture capital investor ("**FVCIs**") which is locked in for a period of one year from the date of purchase by such AIF/ VCF/ FVCI, as the case may be.

Regulation 17 further provided that in case equity shares have resulted in conversion of fully paid up compulsorily convertible securities, the holding period of convertible securities as well as the resultant equity together shall be considered for the purpose of calculation of 1 (one) year.

Position under the ICDR Amendment Regulations: Under the ICDR Amendment Regulations, the equity shares issued to AIFs/ VCFs/ FVCIs shall be locked in for a period of 6 (six) months from the date of purchase of such instrument and in case such equity shares have resulted in a bonus issue, then the holding period of such equity shares against which the bonus issue is made as well as the holding period of the resultant bonus shares together shall be considered for the purpose of calculation of 6 (six) month period subject to (i) bonus issue being made out of free reserves and share premium existing in the books of account of the issuer company at the end of the financial year, preceding the financial year in which the draft offer document is filed with SEBI; and (ii) the bonus issue not being made out of revaluation reserves or unrealised profits of the issuer.

While the reduction of the lock in period from 1 (one) year to 6 (six) months comes as a great breather for AIFs/ VCFs/ FVCIs who come with a limited investment cycle, the clarification around bonus shares is greatly helpful, in allaying the underlying ambiguity about the lock in period/ period of holding of such instruments. Having said that, the conditionalities that are attached to the bonus issue may become cumbersome to meet especially in cases where the bonus issuance is made in the same financial year as the year of submitting the offer document with SEBI.

C. Lock in provisions for preferential allotment

Position under the ICDR Regulations: (i) Under Regulation 167(1) of the ICDR Regulations, specified securities (not exceeding 20% of the total capital of the issuer company) allotted to promoter/ promoter group, on a preferential basis shall be locked in for a period of **3 (three) years** from the date of trading approval. For equity shares exceeding 20% of the total capital of the issuer company, they shall be locked in for a period of **1 (one) year** from the date of the trading approval; (ii) Under Regulation 167 (1) of the ICDR Regulations, specified securities allotted topersons (other than promoters/ promoter group)**,** on a preferential basisshall be locked in for a period of **1 (one) year** from the date of trading approval.

Position under the ICDR Amendment Regulations: (i) Lock in requirement for securities allotted to promoters/ promoter group (upto 20% of the post issue capital) has been reduced to 18 (eighteen) months. For allotment exceeding 20% of the post issue capital, lock in period has been reduced to 6 (six) months; (ii) Lock in requirement for allotment to persons (other than promoters/ promoter group) has been reduced to 6 (six) months.

4. **Conditions for offer for sale for Regulation 6(2) companies**

Position under the ICDR Regulations: Under the ICDR Regulations, for offer for sale in an IPO, selling shareholders can offer equity shares which have been held by them for a period of at least 1 (one) year prior to the filing of the draft offer document and such selling shareholders (not being promoters) can divest part/ whole of their stake in such offer for sale.

Regulation 6(2) of the ICDR Regulations specifically allows issuer companies who do not satisfy the asset/ net worth/ profit criteria to make an initial public offer subject to a minimum allotment of 75% to qualified institutional buyers ("**QIBs**")and to refund the full subscription money if it fails to do so.

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Position under the ICDR Amendment Regulations: Under the ICDR Amendment Regulations, the following changes have been made in relation to issues made under Regulation 6(2):

i. shares offered for sale by selling shareholders, individually or with persons acting in concert, holding more than 20% of pre-IPO shareholding of the issuer company, shall not exceed more than 50% of the pre-IPO shareholding of the issuer company

ii. shares offered for sale by selling shareholders, individually or with persons acting in concert, holding less than 20% of pre-IPO shareholding of the issuer company, shall not exceed more than 10% of the pre-IPO shareholding of the issuer company.

iii. Shareholders holding individually or with persons acting in concert, holding more than 20% of pre-IPO shareholding of the issuer company shall be subject to a lock in of one year from the date of allotment in the IPO and the relaxations available to AIFs/VCFs/ FVCIs as listed in point 4 above shall not be available to shareholders of issuer companies falling under the purview of Regulation 6(2).

In case of an IPO by Regulation 6(2) companies, it was disheartening for the new investors to see the existing shareholders divest as much as 100% of the existing stake in the companies via the offer for sale and therefore the need was felt to balance the interests of the new shareholders as well as the existing shareholders looking to divest in an IPO. While the amendment appears helpful for the Regulation 6(2) companies, this can deter QIBs from investing in non-profitable companies since it restricts the exit flexibility (via an offer for sale) which they enjoyed thus far, thereby leading to more failed IPOs by such category of companies.

It is noteworthy that the exemption from lock in which is otherwise available to AIFs/VCFs/FVCIs under Regulation 17 of the ICDR Regulations seems to be taken away from Regulation 6(2) category of companies, which implies that investors (in the nature of AIFs/ VCFs/ FVCIs) in issuer companies with no track record of operating profits/ do not meet the net worth criteria will need to be locked in for a period of 1(one) year from the date of allotment in an IPO.

5. **Other Changes**

While Regulation 29(2) of the ICDR Regulations specified the cap on the price band in an IPO to be less than or equal to 120% of the floor price, the ICDR Amendment Regulations have added a proviso to the effect that the price band shall be at least 105% of the floor price.

Under Regulation 32 of the ICDR Regulations, a new sub regulation has been added which specifies the allocation within the non-institutional investor ("**NIIs**") category to be as follows: (a) 1/3[rd] of the portion available to the NIIs shall be reserved for applicants with application size of INR 2,00,000 (Indian Rupees Two Lakhs) – INR 10,00,000 (Indian Rupees Ten Lakhs); (ii) remaining 2/3[rd] of the portion to be reserved for applicants with application size of more than INR 10,00,000 (Indian Rupees Ten Lakhs).

Promoters are now permitted to pledge the shares locked in pursuant to a preferential issue provided if pledge of such specified securities is one of the terms of sanction of the loan granted by certain financial institutions and the said loan is to be sanctioned to the issuer company or its subsidiary for the purpose of financing one or more of the objects of the preferential issue.

CONCLUDING REMARKS

The calendar year 2021 has been a watershed moment for the Indian capital markets since companies collectively raised USD 15.4 billion through IPOs during 2021.[4] Although the ICDR Amendment Regulations appear to be a reactionary measure by SEBI to some of the IPOs we witnessed in 2021, the amendments are aimed at the direction of growth and development of the Indian capital markets and at the same time balancing the interests of investors and the issuer companies. The true impact of these amendments however will remain subject to the test of time and successful implementation.

– Eshvar Girish & Harshita Srivastava

You can direct your queries or comments to the authors

1 SEBI vide its board meeting dated December 28, 2021

2 https://www.sebi.gov.in/legal/regulations/jan-2022/securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-amendment-regulations-2022_55351.html

3 Under Regulation 2 (c) of the ICDR Regulations, "**Anchor Investor**" means a qualified institutional buyer who makes an application for a value of atleast ten crore rupees in a public issue on the main board made through the book building process in accordance with these regulations or makes an application for a value of atleast two crore rupees for an issue made in accordance with chapter IX of the ICDR Regulations

4 https://www.livemint.com/market/ipo/highest-amount-of-money-raised-through-ipos-in-2021-see-list-of-blockbusters-11640428123197.html