

Capital Markets Hotline

July 22, 2009

NO MORE SUPERIOR RIGHTS IN LISTED COMPANIES

On July 21, 2009, the Securities and Exchange Board of India ("**SEBI**") issued a letter addressed to the stock exchanges, directing them to amend provisions of the Equity Listing Agreement ("**Listing Agreement**"). The amendment is to include a clause that provides that the issuer (company) shall not issue shares in any manner which may confer on any person, superior rights as to voting or dividend vis-a-vis the rights on equity shares that are already listed.

Background

The issue of equity shares with differential rights (including differential rights as to voting, dividend or otherwise) ("**Differential Shares**") is governed by the provisions of Section 86 (a)(ii) of the Companies Act, 1956, together with the Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001 ("**Rules**"). Under the aforesaid provisions, a company limited by shares could issue Differential Shares not exceeding 25% of the total issued share capital. Differential rights would mean, in the context of voting, any equity share that is entitled to less than one vote per share (excluding the right to vote on alteration of rights attached to such shares), or more than one vote per share. A listed company may issue Differential Shares only if it has obtained the approval of its shareholders through a postal ballot.

The perception by market regulators that the issue of Differential Shares to a person would be detrimental to the interests of the minority shareholders, resulted in the proposal to completely abolish the right of both public and private companies to issue Differential Shares in the Companies Bill, 2008. The objective of enacting this provision appears to have been to bring about equality insofar as equity shares were concerned.

Amendment

The Companies Bill, 2008 is yet to be passed. However, SEBI has issued directions to the stock exchanges to amend the Listing Agreement to make the prohibition effective against listed companies. The direction provides for the addition of a new clause 28A, which states as follows:

"28A. The company agrees that it shall not issue shares in any manner which may confer on any person, superior rights as to voting or dividend vis-à-vis the rights on equity shares that are already listed."

Implications

The amendment speaks of 'shares', without specifying whether the intention is to cover equity shares only. Therefore, the amendment would, on a literal interpretation, include preference shares as well, which, under the Companies Act, 1956, already have superior rights vis-a-vis dividend and liquidation than equity shares. Therefore, this amendment could have the effect of preventing listed companies from issuing preference shares as well.

The direction from SEBI does not clarify what is meant by 'superior' rights. The amendment seems to imply that a listed company cannot issue rights superior to those statutorily conferred to a holder of equity shares in accordance with the Companies Act, 1956. Therefore, a listed company may still be able to issue shares with 'inferior' rights with respect to voting, dividend or otherwise, if this is commercially acceptable to the investor. Further, the meaning of 'superior' rights could also be construed to mean and include affirmative voting rights that are often granted to investors holding such equity shares.

The amendment could have a direct impact on private investment in public equity (PIPE investments) in India. Private investors may be reluctant to invest in a company in the absence of protective provisions, such as affirmative voting rights and covenants that bind the target company.

The direction from SEBI also does not suggest what happens to the Differential Shares already issued by some listed companies (notably Tata Motors and Pantaloon Retail). One view is that Differential Shares issued prior to this

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amendment will have to be rationalized, since listed companies are required to be in compliance with the Listing Agreement at all times. If this is the case, the amendment neither addresses the time nor the manner in which this rationalization should be achieved. Conversely, another view is that since the Listing Agreement governs the listed equity shares, the amendment is intended to cover only prospective issuances of Differential Shares, and will not affect issuances made before the date of the amendment.

Conclusion

The amendment lacks clarity on the issues pointed out above, and could lead to confusing interpretations. The need of the hour is for SEBI to clarify these issues at the earliest. Considering the grim state of investments generally, it would augur well for the capital markets regulator to stimulate investment activity, rather than stifle it.

Further, considering the object of the abolition, the amendment is a weak move towards protection of minority shareholders in a company. Since the Companies Act provides for adequate grievance redressal mechanisms in the form of remedies against mismanagement and oppression, these may be a more appropriate way of ensuring the protection of minority interests. Equality of voting rights may not achieve the desired minority protection objective, based on several factors most significant of which is public shareholder apathy. We will continue to update you as this issue plays out, but for the nonce it certainly appears that shares with "superior rights" are passing into the annals of history.

- Rohini Agarwal & Kartik Ganapathy

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