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SHARES WITH DIFFERENTIAL VOTING RIGHTS IN INDIA - AMENDMENTS TO THE REGULATORY FRAMEWORK

If you have questions or would like additional information on the material covered herein, please contact:

Ms. Seema Jhingan, Partner
(sjhingan@lexcounsel.in)

Mr. Dhruv Manchanda, Principal Associate
(dmanchanda@lexcounsel.in)

Mr. Ankit Sahoo, Associate
(asahoo@lexcounsel.in)

LexCounsel, Law Offices C-10, Gulmohar Park New Delhi 110 049, INDIA.
Tel.:+91.11.4166.2861
Fax:+91.11.4166.2862

SHARES WITH DIFFERENTIAL VOTING RIGHTS IN INDIA - AMENDMENTS TO THE REGULATORY FRAMEWORK

In recent past, there has been a lot of debate around a proper regulatory framework being put in place to enable Indian companies issue shares with differential voting rights (“**DVR(s)**”) which would enable the promoters to continue retaining control over their companies. Pursuant to this ongoing debate, the Securities Exchange Board of India (“**SEBI**”) on March 20, 2019 issued a Consultation Paper on “Issuance of shares with Differential Voting Rights” for devising a structure for regulation of shares with DVR(s) under two broad heads, namely, issuance of shares by companies whose equity shares are already listed on stock exchanges; and companies with equity shares which have not been listed as on date but are proposed to be offered to public. Upon receipt of comments of the Primary Market Advisory Committee of SEBI and market participants including issuers and investors on the Consultation Paper, SEBI at its board meeting on June 27, 2019 approved a framework for issuance of shares with DVR vide a press release no. 16/2019.

Some of the key proposals as have been approved by the SEBI vis-à-vis issuance of shares with DVR(s) *inter alia* include the following:

1. **Eligibility:** A company having superior voting rights shares would be permitted to do an initial public offering of only ordinary shares subject to fulfilment of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 and the following conditions:

Recommended by:



- a. Issuer company is a tech company (as defined under the Innovators Growth Platform) 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.
 - b. The shareholder holding shares with superior voting rights should be a part of the promoter group whose collective net worth (i.e., excluding the shares held in the issuer company) does not exceed INR 500 crores.
 - c. The shares with superior voting rights should have been issued only to the promoters/founders holding executive position in the issuer company.
 - d. The issue of shares with superior voting rights must have been authorized by a special resolution passed at a general meeting of the shareholders.
 - e. The shares with superior voting rights must have been held for a period of at least 6 months prior to the filing of the Red Herring Prospectus.
 - f. The shares with superior voting rights should have voting rights in the ratio of minimum 2:1 to maximum 10:1 compared to the ordinary shares.
2. ***Listing and Lock-in for Shares with Superior Voting Rights:*** The shares with superior voting rights will also need to be listed on the stock exchange after the public issue made by the issuer company and after the initial public offering, such shares shall be under a lock-in until their conversion into ordinary shares. Furthermore, the shares with superior voting rights are neither permitted to be transferred inter se the promoters nor any pledge or lien is permitted to be created on them.
 3. ***Rights of Shares with Superior Voting Rights:*** The shares with superior voting rights are to be treated at par with the ordinary equity shares in every respect, including dividends, except in case of voting on resolutions. The total voting rights of the shareholders holding shares with superior voting rights combined with the ordinary shares held by such shareholders are not permitted to be more than 74%, post listing of the issuer company.
 4. ***Enhanced Corporate Governance:*** All companies having shareholders with superior voting rights are subject to enhanced corporate governance as follows:

a. At least ½ of the Board and 2/3rd of the Committees (excluding Audit Committee) as prescribed under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 [**“SEBI (LODR) Regulations”**] shall comprise of Independent Directors; and

b. Audit Committee shall comprise only of Independent Directors.

5. Coat-tail Provisions: Post the initial public offering by the issuer company, the shares with superior voting rights shall be treated as ordinary equity shares in terms of the voting rights (i.e., one superior voting right share shall have only one vote) in the following circumstances:

a. Appointment or removal of independent director and/or auditor;

b. In case where promoter is willingly transferring control to another entity;

c. Related party transactions in terms of SEBI (LODR) Regulations involving the shareholder holding shares with superior voting rights;

d. Voluntary winding up of the company;

e. Changes in the company's Memorandum or Articles of Association except for changes affecting the shares with superior voting rights;

f. Initiation of a voluntary resolution plan under the Insolvency and Bankruptcy Code;

g. Utilization of funds for purposes other than business;

h. Substantial value transaction based on materiality threshold as prescribed under the SEBI (LODR) Regulations;

i. Passing of special resolution in respect of delisting or buy-back of shares; and

j. Any other provision, as may be notified by SEBI in this regard, from time to time.

6. Sunset Clauses for Shares with Superior Voting Rights: Shares with superior voting rights shall be converted into ordinary equity shares in the following circumstances/events:

a. Time Based: Shares with superior voting rights shall be converted into ordinary shares on the 5th anniversary of the listing. The validity can be extended once by 5 years through a resolution. The shareholder holding shares with superior voting rights would not be permitted to vote on such resolutions.

b. Event Based: Shares with superior voting rights shall compulsorily get converted into ordinary shares on occurrence of certain events such as demise, resignation of shareholders holding shares with superior voting

rights, merger or acquisition where the control would be no longer with the shareholder holding superior voting rights, etc.

- 7. Fractional Right Shares:** SEBI has further stated that issue of fractional rights shares by existing listed companies shall not be allowed. It has been clarified that the need for issue of fractional rights shares by listed companies may however be reviewed after gaining enough experience with the use of the shares holding superior voting rights.

Amendments to the Companies (Share Capital and Debenture) Rules, 2014 (“SCD Rules”) vis-à-vis Issue of Shares with Differential Voting Rights:

Pursuant to the framework for issue of DVR issued by the SEBI, the Ministry of Corporate Affairs, vide notification dated August 16, 2019, introduced the Companies (Share Capital and Debenture) Amendment Rules, 2019 (“**SCD Amendment Rules**”) to *inter alia* amend certain requirements prescribed under the SCD Rules for issue of shares with DVR, which amendments are as below:

- a. Rule 4(c) of the SCD Rules, pursuant to amendment vide the SCD Amendment Rules, prescribes that the voting power in respect of shares with differential rights of the company shall not exceed 74% of the total voting power including voting power in respect of equity shares with differential rights issued at any point of time.

Prior to the amendment, Rule 4(c) stated that the shares with differential rights shall not exceed 26% of the total post-issue paid up equity share capital including equity shares with differential rights at any point of time.

- b. SCD Amendment Rules have deleted the restriction that for the purposes of issuance of shares with differential voting rights, the company must have consistent track record of distributable profits for the last three years.

Conclusion:

The framework for issue of DVR shares is a welcome move especially for new technology companies having asset light models with no profitability and in continuous need of equity or debt funding for growth. The past decade has shown that repeated equity funding substantially dilutes promoter’s stake and therefore control over business and decision making in the company. Retaining founder’s interest and control in the business is not only of great value to the shareholders but also important for the growth of the business. Hopefully, the new regulations would aid Indian growth start-ups and their promoters to continue retaining greater control over their companies. However, the right to

issue shares with superior voting rights has come with many checks and balances including restrictions and increased compliances and it is yet to be seen if the promoters would be ready to undertake these additional compliances to retain control.

Feedback

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