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EY Transaction Tax Alert

Unlisted company preferential allotment rules



This alert summarises the draft rules governing preferential issue of shares by unlisted Public Companies

Executive Summary

This alert summarizes key provisions of the draft Unlisted Public Companies (Preferential Allotment) Rules, 2011 relating to preferential issue of shares by unlisted Public Companies¹, issued by Ministry of Corporate Affairs, Government of India on May 24, 2011 for public comments. The last date for submitting comments / recommendation to the Ministry is June 20, 2011.

Background

Preferential allotment means issue of shares by a company to a select group of shareholders, investors and promoters (and their relatives) on a private placement basis. Preferential allotment of shares by companies has been a widely used source of fund raising by the companies.

Section 81(1A) of the Companies Act, 1956 (the 'Act') gives power to a public company to issue shares on a preferential basis. While there are stringent rules that govern such kind of shares issue by listed Public Companies, the rules are not as stringent for an unlisted public company. Preferential issue of shares by unlisted Public Companies are hitherto governed by Unlisted Public Companies (Preferential Allotment) Rules,

¹ As defined under Section 3 of the Act

2003 ('Existing Rules'). Ministry of Corporate Affairs has issued draft Unlisted Public Companies (Preferential Allotment) Rules, 2011 ('Draft Rules') which seeks to replace the Existing Rules.

The Draft Rules proposes certain significant changes, including higher disclosures requirements, keeping securities in the Demat Form, etc and would impact close to 40,000 unlisted Public Companies in India.

Following are the key provisions of the Draft Rules.

Key provisions

Applicability of the Draft Rules

- ▶ The Draft Rules are applicable on any issue of equity shares and convertible instruments by unlisted Public Companies¹ on a preferential allotment / private placement basis.

Central government approval in case of issue of convertible instruments of more than Rs. 5 crores

- ▶ The Draft Rules provides that where a company proposes to raise cumulative of more than Rs. 5 crore by way of preferential allotment of convertible instruments (eg. convertible debentures) which are convertible into or exchanged with the equity shares of the company at a later date, the company

would be required to obtain a prior approval of the Central Government.

Pricing of the warrants

- ▶ In case where warrants are issued by the company on a preferential basis, the price of the resultant share shall need to be determined upfront by the company.

Share to be issued in Demat Format

- ▶ Under the Existing Rules, securities could be issued and retained either in physical or in dematerialized format. However, the Draft Rules propose that any securities which are proposed to be issued under preferential allotment or private placement shall be kept in Dematerialized form.

Offer Document, related disclosures and compliances

- ▶ A company proposing to issue shares on a preferential basis shall be required to make detailed disclosures in the Offer Document, key disclosures being:
 - ▶ Details of the issuer;
 - ▶ Nature, number, price and amount of securities offer and size of the total issue;
 - ▶ Details of outstanding loans and advances;

- ▶ Aggregate amount proposed to be raised through all the stages of offer made through offer documents;
 - ▶ Names of loss making group companies;
 - ▶ Any investments in debt instrument which are unsecured or which carries interest rate lower than the market rate;
 - ▶ Negative cash flows;
 - ▶ Amount of contested tax demands;
 - ▶ Details of project for which issue is made along with schedule of implementation;
 - ▶ Outstanding litigation which have material impact on the issuer.
- ▶ The Offer Document shall need to be approved by the shareholder by way of special resolution in a general meeting of the company and shall be filed with the Registrar of Companies ('RoC').
 - ▶ Further, the company shall file a Return of Allotment with the RoC within 30 days of allotment of shares.
 - ▶ The issue of shares on private placement basis shall not be open for a period of more than 30 days and a subsequent issue of shares on preferential basis could only be made after a period of 60 days from the closure of issue.
 - ▶ A company shall be required to file a compliance certificate issued by a practicing Chartered Accountant / Company Secretary / Cost Accountant with the concerned RoC along with the return of allotment. Such

certificate shall certify that the allotment is made in accordance with these rules

Our Comments

- ▶ Unlisted Public Companies are not subject to the rigorous public scrutiny as compared to the listed companies.
- ▶ Detailed disclosures, prior central government approval in case of issue of convertible instrument beyond the prescribed threshold and need for keeping shares in Demat form are certain proposal that would result in higher level of accountability by the issuer company and regulatory scrutiny thereby.
- ▶ It would also be important to examine the companies that would be covered by the Draft Rules as the definition of a Public Company under the Act is very wide and may also include a private company (e.g. subsidiary of a Public Company is a Public Company under the Act).

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