INSIGHT

Special Edition

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Overhaul of the ICDR Regulations

On September 11, 2018, the Securities and Exchange Board of India (“**SEBI**”) notified the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (“**New Regulations**”). The New Regulations will come into force on November 10, 2018, and replace the existing SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (the “**Old Regulations**”).

The New Regulations were issued pursuant to the recommendations of the Issue of Capital & Disclosure Requirements Committee (the “**ICDR Committee**”) constituted by SEBI in June 2017 to review the Old Regulations under the chairmanship of Mr. Prithvi Haldea. The objective of the ICDR Committee was to simplify the language and complexities, to make the regulations more reader friendly and to incorporate changes and new requirements, which have occurred due to changes in market practices and regulatory environment.

The New Regulations have streamlined some of the disclosure requirements and have also attempted to reduce disclosure in offer documents. The New Regulations have made certain key changes including the following:

- Reduced the period of disclosure of restated consolidated financial statements for initial public offerings ("**IPOs**") from five to three financial years and any stub period. The standalone financial statements are required to be uploaded on the website of the issuer instead of being disclosed in the offer document.

- Reduced the timeline for announcement of floor price or price band from five to two working days for IPOs.

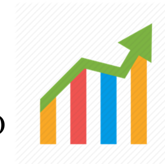
- Limited the disclosure of litigation involving group companies to only such litigation that has a material impact on the issuer.

- Clarified the conditions for undertaking an offer for sale in IPOs permitting conversion of fully paid-up compulsorily convertible securities offered in the IPO prior to filing of the offer document (red herring prospectus) instead of the draft offer document (draft red herring prospectus).

- Imposed a blanket restriction on eligibility for undertaking fast track rights issues in case of any audit qualification(s) in the financial statements included in the letter of offer

This update discusses some of the key changes in the process and disclosure required in relation to capital raising through IPOs, rights issues, preferential issues and qualified institutions placements.

Initial Public Offerings



Significant changes with respect to IPO are set out below:

- *Financial statements*: The disclosure requirements with respect to inclusion of financial statements in the offer document have been modified and issuers are now required to provide only the restated consolidated financial statements for a period of three financial years (and any stub period) unlike the previous disclosure requirements where restated standalone and consolidated financial statements for a period of five financial years (and any stub period) had to be included as per the Old Regulations.

- *Price band/floor price announcement:* The timeline for announcement of the floor price or price band has been reduced to two working days (from five working days) prior to opening of the IPO, thereby reducing the overall issue timeline and minimizing impact of volatility in markets on the IPO.

- *Ability to convert securities offered in the IPO closer to launch of the IPO*: Conditions for offer for sale have been relaxed to permit conversion of fully paid-up compulsorily convertible securities prior to filing of the offer document (red herring prospectus) subject to compliance with, *inter alia*, completion of holding period of one year prior to the draft offer document (draft red herring prospectus) and including "full disclosure" of the terms of conversion in the draft offer document (draft red herring prospectus). This is an important clarification, since it permits selling shareholders to hold the shares proposed to be sold in the IPO as convertible securities at the draft offer document stage and convert such securities closer to the launch of the IPO, enabling them to take into consideration market conditions and other related factors.

- *Standalone financial information*: Issuers are required to upload standalone audited financial statements of the issuer and its material subsidiaries (subsidiaries contributing 10% or more of the consolidated turnover, net-worth or profit before tax of the issuer) for the three full financial years preceding the date of filing of offer document, on the issuer's website. It is unclear whether this provision seeks to introduce the concept of incorporation by reference and if it is intended for the issuer and its board continue to have prospectus liability for such additional financial information. It is also essential to analyze the manner in which auditors would provide any certifications on such financial information for the purpose of financial due diligence by the lead managers.

- *Proforma financial information*: Proforma financial information is required to be disclosed in the event the issuer or its subsidiaries have made a material acquisition or divestment, including acquisition or divestment of any business of the issuer or its subsidiaries and any deemed disposal, after the latest period for which financial information is disclosed in the offer document. However, this deviation from the Old Regulations is not consistent with global practices where proforma financial information in offer documents is required to be provided for any acquisition or divestment made by an issuer or its subsidiary after the last full financial year for which financial information is included in the offer document. Further, the parameters for assessing materiality have changed from asset and turnover to net worth, profit before tax and turnover. This is an important change as it substantially widens the scope of the provision and is likely to increase the number of transactions that would require disclosure of proforma financial information.

- *Group company litigation*: The New Regulations have limited the requirement of disclosure of litigation involving group companies and specified that the issuer is required to disclose only such pending litigation involving a group company which has a material impact on the issuer. To identify the matters that require disclosure under this provision, the board of directors of the issuer would first need to analyse if any of the group companies identified as per the New Regulations, is material to the issuer. For example, a group company could be material if it is a key supplier or an important customer of the issuer. One would then be required to analyse litigation involving such material group companies and determine whether such litigation has a material impact on the issuer and disclose such litigation in the offer document.

We believe this is a fundamental change and could substantially reduce size of the offer document. Previously, group company litigation included many matters which were not material to the issuer or the investors but definitely added bulk to the offer document. Whilst the new requirement would require the issuer and its advisors to exercise judgment in determining material litigation that require disclosure, we believe this will streamline disclosure in the offer document.

- *Pledge of locked-in specified securities*: The New Regulations have permitted the pledge of locked-in securities post IPO with a systemically important non-banking finance company ("**SI-NBFC**") and a housing finance company in addition to scheduled commercial banks or public financial institutions which were already permitted. While this expands the category of lenders from whom financing may be availed, the New Regulations also state that lock-in shall continue pursuant to any invocation of the pledge and such transferee shall not be eligible to transfer the specified securities until the expiry of the stipulated lock-in period.

Certain other changes in relation to IPOs include:

- The eligibility requirement for firm arrangements of finance through verifiable means towards 75% of the stated means of finance has been clarified to relate to a "specific project" proposed to be funded from the IPO proceeds. The intention appears to address the ambiguity of applicability of "firm arrangement" to the non-capital expenditure related objects such as repayment of loans and working capital requirements and give effect to the recommendations of the Malegam Committee in 2004. However, the term "specific project" has not been defined to mean only those projects which involve capital expenditure and therefore, we believe that the change still does not address the ambiguity with respect to applicability of firm arrangement to non-capital expenditure related objects.

- The definition of "group companies" has been brought in line with market practice to specifically exclude promoters and any subsidiaries of the issuer, and include such companies with which the issuer had related party transactions during the period for which financial information is disclosed in the offer document along with any other company considered material by the board of directors of the issuer. However, the definition still does not permit issuers to apply materiality to the related party transactions and accordingly, all related parties which had transactions during the period for which financial information is disclosed in the offer document would, by default, qualify as group companies. Thus, disclosure about their financials and other corporate information would still need to be disclosed.

- The Old Regulations restricted entities from undertaking an IPO in case any person was holding any outstanding convertible securities or any other right which would entitle such person to have an option to receive equity shares. The exemption from such restriction included outstanding options granted to employees under a stock option scheme. However, the Old Regulations did not extend this exemption to options held by ex-employees, which led to issuers having to accelerate the vesting of options and allotment of shares to ex-employees prior to filing of the draft offer document and regularly monitor the option holders during the IPO process. The New Regulations have relaxed this condition to permit outstanding options granted to employees, whether currently in employment or not, pursuant to a stock option scheme in compliance with the Companies Act, 2013 and relevant Guidance Note on accounting standards. Similar changes have also been made with respect to the regulations providing for exemptions from lock-in of pre-issue equity shares allotted to employees pursuant to a stock option scheme or transferred from stock option trusts to employees, whether in employment or not. This is an important clarification especially considering that the SEBI (Share Based Employee Benefits) Regulations, 2014 permits ex-employees to continue to hold vested options in accordance with the relevant stock option scheme, and any acceleration of vesting or exercise could potentially been considered as detrimental to such ex-employees.

- Exemption has also been provided to issuers from providing any comparative financial information for the relevant stub period. Issuers may, however, disclose comparative financial information for the stub period on a voluntary basis which would allow investors to make a more meaningful analysis of the issuer's financial information for the most recent period. This ability, we believe, is an important addition.

- The New Regulations have relaxed the disclosure requirements for pre-IPOs in the draft offer document by allowing disclosure of either total number of securities or amount proposed to be raised unlike the Old Regulations which required disclosure of both, number of securities and amount to be raised. Disclosure of number of shares or amount proposed to be raised from issue of shares pursuant to exercise of employee stock options has been expressly is excluded from this requirement.

- The New Regulations permit issue of more than one warrant with a specified security pursuant to an IPO.

- The requirement of the issue price per share being more than Rs. 500 in case the face value of equity shares of the issuer is less than Rs. 10 has been removed. This will allow greater flexibility in pricing for the IPO.

- The New Regulations require a confirmation that the issuer, its promoters, promoter group and selling shareholders are in compliance with the recently notified Companies (Significant Beneficial Ownership) Rules, 2018.

- The New Regulations permit issuers to voluntarily provide proforma financial information when such acquisitions do not trigger the specified materiality threshold. This is a key clarification and allows issuers to determine if such additional financial information is a material disclosure for potential investors. However, implementation of this may require discussion with the auditors.

- The safety net mechanism has been removed in the New Regulations.

- The New Regulations permit IPOs to be underwritten only to the extent of minimum subscription, instead of the entire issue being underwritten.

- For the purposes of meeting promoters' contribution requirements, in addition to alternative investment funds ("**AIFs**"), foreign venture capital investors, scheduled commercial banks, public financial institutions and insurance companies have been allowed to contribute in case of any shortfall in promoters' contribution without being identified as promoters.

- A clarification has been included that the General Information Document ("**GID**") should not be made part of the offer document. This will reduce the size of offer documents as existing market practice was to include updated GID as part of the offer document.

- Reservation in a public offer has been limited to only two categories being (i) employees and (ii) shareholders (other than promoters and promoter group) of listed subsidiaries or listed promoter companies. Reservations for depositors, bondholders and subscribers to services and shareholders of listed group companies of the issuer allowed under the Old Regulations have been removed.

- Whilst the Old Regulations allowed extension of IPO period only upon revision of price band, the New Regulations allows extension in situations such as *force majeure* and banking strike subject to the overall IPO period not exceed ten working days.

- The requirement of confirmation from the lead managers in their due diligence certificate that the profits from related party transactions have arisen from legitimate business transactions has been removed. The lead managers will now be required to confirm that the related party transactions entered into by the issuer during the period disclosed in the offer document are in accordance with applicable laws.

- Insurance companies, AIFs and Foreign Portfolio Investors ("**FPIs**") (other than Category III FPIs) associated with the lead managers have also been permitted to participate in the Anchor Investor category in addition to mutual funds associated with the lead managers.

Rights Issues

Significant changes with respect to rights issues are set out below:

- *Eligibility for undertaking fast track rights issues*: Whilst audit qualifications affected eligibility for undertaking fast track rights issues under the Old Regulations, the Old Regulations allowed for application of materiality threshold of more than 5% of the net profit or loss after tax of the issuer for an audit qualification to determine if such qualification affect the issuer's eligibility. The New Regulations have included a blanket restriction on eligibility to undertake fast track rights issues if there is any audit qualification in the financial statements which are included in the letter of offer. Audit qualifications are defined as those qualifications under the applicable accounting standard relating to modification of the opinion of the auditor's report and requires a qualified opinion, adverse opinion or disclaimer of opinion for material misstatements. However, eligibility condition for fast track further public offers continue to retain materiality threshold for audit qualification. Companies that have qualifications in their audit report will need to analyze this further to determine if they are eligible for the fast track rights issues.

- *Codification of market practice in relation to underwriting and priority in allotment:* The limited instances of underwriting in rights issues in the past have typically excluded subscription by promoter and promoter group. Further, with respect to priority of allotment in a rights issue, the issuers have typically disclosed the manner of priority of allotment in the offer document in consultation with intermediaries. Waterfall arrangements have typically included the first right to shareholders and renouncees, followed by additional securities applied for by shareholders on an equitable basis and lastly, additional shares applied for by renouncees on a proportionate basis. Both the aforesaid market practices have been codified in the New Regulations. This may potentially affect the flexibility that the board of directors of the issuer and lead managers had with respect to underwriting and priority in allotment in rights issues.

- *Disclosure Requirements:* The earlier requirement to disclose criminal matters, material violations and economic offences that have arisen in the last ten years (which was even more onerous than IPO disclosure requirements) have been removed with and only pending matters are required to be disclosed. The materiality threshold for disclosure of litigation has been aligned with the materiality threshold determined under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (the "**SEBI Listing Regulations**"). Additionally, the requirement to disclose certain financial line items as 'working results' which typically involved disclosure of select financial information for a period post the last disclosed financial statements, has been removed.

Some other changes in relation to rights issues include:

- The minimum size of rights issues for applicability of rights issue related regulations has been increased from Rs. 50 lakhs to Rs. 10 crore.

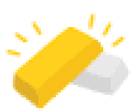
- While the abridged letter of offer could only be dispatched through registered or speed post under the Old Regulations, the New Regulations allow issuers to also use courier or electronic transmission mechanism which is consistent with the provisions of the Companies Act, 2013.

Preferential Issues

Significant changes with respect to preferential issues are set out below:

- *Relaxation of Eligibility Requirements for Promoter and Promoter Group:* Under the Old Regulations, promoter and promoter group entities which had sold any equity shares held in the issuer during the six months preceding the relevant date for the preferential issue were ineligible for allotment in the preferential issue. The New Regulations have included exemptions to this restriction namely, *inter-se* transfers among promoter and promoter group under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and transfers due to invocation of pledge by a scheduled commercial bank, public financial institution, SI-NBFC, mutual fund or insurance company.

Some other changes in relation to preferential issues include:



- The New Regulations continue to exempt preferential issues made under the Insolvency and Bankruptcy Code, 2016 (the "**IBC Code**") or RBI framework for resolution of stressed assets. However, requirements of lock-in would apply to such preferential issues.

- A specific requirement of valuation by an independent valuer has been included for preferential issues to any person (not to only promoters and related entities) involving consideration other than cash.

Qualified Institutions Placement

The New Regulations have done away with Institutional Placement Programme ("**IPP**") and have combined certain erstwhile IPP related provisions with the regulations governing qualified institutions placements ("**QIP**") thereby allowing QIP as a method to meet minimum public shareholding norms either by fresh issue or a secondary sale by promoters or members of the promoter group. Accordingly, companies are now permitted to undertake a QIP within a year of listing to comply with minimum public shareholding ("**MPS**") norms. However, the requirement for shareholders' resolution has been removed for the offer for sale by promoters or members of the promoter group.

Some of the other significant changes with respect to QIPs are set out below:

- *Restrictions on amount raised*: The New Regulations remove the restriction that the amount raised through QIPs in a financial year should not exceed five times the net worth of the issuer. This is an important change allowing companies having low net worth or even a negative net worth to raise capital by way of QIPs as participation in QIPs is restricted to sophisticated investors.

- *Disclosure Requirements of Litigation:* Litigation is now required to be disclosed in accordance with the materiality policy adopted by the issuer under the SEBI Listing Regulations. Whilst alignment of disclosure with ongoing disclosure obligation is understandable, this change may either require issuers to re-evaluate and review their existing materiality policies or significantly restrict extent and level of litigation disclosure in the offer document.

- *Qualified institutional buyers belonging to the same group*: The term 'Qualified Institutional Buyers belonging to the same group' being treated as a single allottee, which was relevant for determining minimum number of investors in QIPs, has been modified and includes entities in which the investor holds not less than 15% voting rights, exercises control or where there is a common director (other than independent and nominee directors) between two investors. The definition could have been aligned with existing definitions of "group" in other legislations so as to ensure consistency and to clearly establish control.

Common Changes

The New Regulations have also made certain changes that are applicable across capital issuances governed by it. Certain key highlights are as follows:

- *Definition of promoter group*: Shareholding threshold for investment in body corporates in relation to identification of promoter group has been increased from 10% to 20%. This is an important change as the erstwhile threshold of

10% also covered entities in which the promoter did not have a substantial investment.

- Eligibility conditions have been modified to disallow entities from undertaking, *inter-alia*, an IPO, rights issue, preferential allotment and QIP if any of its promoters or directors is categorized as a fugitive economic offender ("**FEO**") under the Fugitive Economic Offenders Act, 2018. Accordingly, if the promoter of a listed issuer becomes an FEO, the issuer may wish to depromoterise the FEO. However, listed issuers can only undertake depromoterisation in terms of the SEBI Listing Regulations or with the specific consent of the SEBI. Further, the stock exchanges require consent of the promoter for any such reclassification, which FEO promoters may refuse to provide. Since the SEBI Listing Regulations do not prescribe any process for depromoterisation of a promoter who is an FEO, it will have to be seen how issuers undertake such depromoterisation.

- The requirement of reporting all transactions in securities by the promoter and promoter group to stock exchanges (within 24 hours of such transaction) will now apply from the filing of the draft offer document (draft red herring prospectus) and will continue until the closure of the issue. This reporting was earlier required only from the time of filing the offer document (red herring prospectus in case of an IPO) as all transactions between the draft offer document and offer document are already reflected in the offer document. This will require additional compliance and monitoring by the issuers from the time of filing the draft offer document.

Way Forward

The New Regulations take a step towards simplifying the regulations and aligning them to market practice. However, certain disclosure related issues such as further reducing disclosure of financial and corporate information of group companies, removing requirements of past litigation such as disclosure of past actions for violation of securities laws, materiality threshold for disclosure of all litigation including criminal and regulatory actions, and limiting disclosure of capital structure build-up for a specific period instead of requiring disclosure from incorporation, should be taken up in the future to ensure that Indian offer documents are easier to read and highlight important issues for potential investors. Similarly, certain substantive provisions may need consideration such as release of pledge on shares required for promoters' contribution (which requirement has now been relaxed for further public offers but not for initial public offers) and formal recognition of the concept of incorporation by reference and reducing disclosure in further capital raising by allowing reference to an annual information memorandum.

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