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Analysing developments impacting business

SEBI INTRODUCES KEY CHANGES TO FUND RAISING PROCESSES AND DISCLOSURES AND CORPORATE GOVERNANCE

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Background:

Securities and Exchange Board of India (**SEBI**) in its board meeting dated 29 September 2022 (**Board Meeting**) has *inter alia*, approved an alternative pre-filing mechanism for offer documents in initial public offers (**IPOs**); additional disclosures to substantiate basis for IPO issue price; monitoring of proceeds raised through qualified institutions placement (**QIPs**) and preferential issues; and alternative approval process for appointment and removal of independent directors of listed companies.

I. Optional pre-filing of offer document:

The existing 4 (four) stage filing process for an IPO on main board includes: (i) filing draft red herring prospectus (**DRHP**) with the SEBI and stock exchanges, making it available for public comments for 21 (twenty one) days and seeking SEBI's observations as well as in-principle approval from stock exchanges; (ii) confidentially filing updated DRHP (**UDRHP**) with SEBI for confirmation; (iii) post SEBI's go ahead, filing red herring prospectus (**RHP**) with Registrar of Companies (**RoC**), SEBI and stock exchanges; and (iv) filing prospectus with SEBI, RoC and stock exchanges post pricing.

Pursuant to various representations made by issuers and with the primary intention of maintaining confidentiality of sensitive business information at the initial stages, SEBI has approved an alternate 5 (five) stage filing mechanism whereby, an issuer so desirous, can file the DRHP confidentially with SEBI for its observations, and with stock exchanges for in-principle approval. Once SEBI's observations are incorporated, an updated DRHP (**UDRHP-I**) shall be made publicly available for comments for 21 (twenty-one) days. This is followed by confidential filing of a second updated DRHP (**UDRHP-II**) with SEBI. Upon approval of this UDRHP-II, the issuer may proceed to file the RHP with RoC, SEBI and stock exchanges and launch the IPO.

Pre-filing mechanism addresses certain concerns of prospective issuers by allowing them to kick-start the IPO process, while testing waters to determine market sentiment and thereafter deciding whether they wish to proceed with the IPO. Accordingly, at this stage, issuer's sensitive business data and any competitive advantage thereof is protected from being made available to public / competitors. Speculation on price and timing of the issue in the market in this interim period is also avoided.

Pre-filing will allow issuers to: (i) make more recent information available for public consumption and for marketing the issue (in contrast to existing mechanism where marketing is typically done based on information in the DRHP, which is updated only at the RHP stage, shortly before opening of the IPO); (ii) to resolve observations and

comments of SEBI on confidential basis; and (iii) get more recent feedback from institutional investors to gauge initial demand and pricing. This will also allow an updated document to be available to prospective investors for an extended time. If pre-filing mechanism is opted for by an issuer, it is likely to increase IPO timelines.

II. KPI disclosures under the Basis For Issue Price section:

SEBI, to strengthen the disclosure requirements for justifying issue price in an IPO, has mandated certain additional disclosures in offer documents and price-band ad, which include:

i) key performance indicators (KPIs);

ii) price per share of the issuer based on primary issuances and secondary sale/acquisitions, in the 18 (eighteen) months preceding the IPO. In the event there are no such transactions in the preceding 18 (eighteen) months, details of last 5 (five) primary or secondary transactions with the look back period of 3 (three) years from IPO are to be disclosed; and

iii) weighted average cost of acquisition (**WACA**) based on primary and secondary transactions, along with ratio against IPO floor price and cap price.

SEBI's intent seems to be to strengthen justification of IPO pricing through additional disclosures, which are key to the evaluation of pricing levels by prospective investors. Issuers have historically disclosed business or industry specific KPIs in offer documents, especially for marketing purposes. Issuers will now be required to disclose such KPI in the 'Basis for Issue Price' section of offer documents, with the understanding that such KPIs have a bearing on arriving at the IPO price. It is likely that this decision stems from SEBI's evaluation of the performance of recently listed new age tech companies (**NATCs**) which are largely backed by private equity investors and generally loss-making in the growth phase. The disclosures on past transactions and past fund raising by the issuers seek to reduce the information asymmetry between pre-IPO and IPO investors.

SEBI has also decided to impose additional responsibility on independent directors for issue price determination by requiring a committee of independent directors to recommend that the price band is justified based on quantitative factors / KPIs compared with the WACA of primary issuances and secondary transactions. Considering that the issue price is to be approved by the board of directors irrespectively, it is unclear as to how much the independent directors can bring additional value in the process.

III. Monitoring of issue proceeds raised through QIPs and Preferential Issues:

Under Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) 2015 (**LODR Regulations**), while listed companies are required to disclose the utilization of funds raised through QIPs or preferential issue and explanation for any variation in its annual report every year until such funds are fully utilized, there was no requirement for monitoring of utilisation of proceeds by an external agency (except in case of preferential issues of companies having stressed assets which required a public financial institution or scheduled commercial bank to monitor the issue proceeds). SEBI has now mandated monitoring of utilization of issue proceeds for all preferential issues and QIPs of INR 100 (one hundred) crore, by credit rating agencies (**CRAs**), in the same manner as public and rights issues, thus aligning the regulatory framework.

The obligation on a company to make quarterly disclosures to stock exchanges for deviations and variations in use of proceeds from what is disclosed in the offer documents or stated in the explanatory statement to the notice of general meetings, and the audit committee's obligation to review such statements remains the same. However, the appointment of an independent CRA will add an additional layer of check and balance. Potentially, the current requirement under Regulation 32 (6) and 32(7) of LODR Regulations applicable to public and rights issues will also be extended to preferential issues and QIPs thereby requiring companies to submit comments or report from monitoring agency to be placed before the audit committee and submitted to the stock exchanges on a quarterly basis.

IV. Alternative approval process for the appointment and removal of independent directors:

To strengthen the corporate governance framework of listed companies, SEBI had through an amendment to the LODR Regulations on 3 August 2021, introduced Regulation 25 (2A) which requires the appointment, re-appointment and removal of independent directors by a listed entity to be subject to shareholder's approval by way of special resolution. Prior to this amendment, per the Companies Act 2013, the appointment and removal of an independent director required shareholder's approval through ordinary resolution and only re-appointment required special resolution. To provide flexibility to the companies in appointment of independent directors, SEBI has approved an amendment to Regulation 25(2A) of LODR Regulations whereby, in the event requisite majority for such special resolution does not come through, the independent director can still be appointed if it is approved by: (i) majority of shareholders; and (ii) majority of the minority shareholders. This flexibility will ease the otherwise arduous process of identifying suitable candidates and onboarding of independent directors for companies. SEBI seems to suggest an objective approval structure similar to jurisdictions like Israel which has provisions for appointment of independent directors through minority shareholders, and United Kingdom, where a dual voting structure exists for premium listed companies which have a controlling shareholder ie, approval of both - shareholders as a whole and independent shareholders, further in case either fails, a second vote of all shareholders (including controlling shareholder) may be taken.

Another significant change brought by SEBI is greater flexibility to the existing framework for offer for sale (OFS) of shares through the stock exchange mechanism by *inter alia*, (i) removing the shareholding threshold of minimum 10% of share capital - for non-promoter shareholders to be eligible to participate in the OFS, thereby opening this mechanism to other non-promoter shareholders; (ii) reducing the cooling off period for seller to purchase/sell shares prior to or post the OFS, from 12 (twelve) weeks to a range of 2 (two) weeks to 12 (twelve) weeks based on liquidity of such securities; (iii) allowing retail investors to bid for the unsubscribed portion of non-retail segment; and (iv) extending the OFS through stock exchange mechanism to listed real estate investment trusts / infrastructure investment trusts.

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