Private Placement of securities: new laws, better laws

Introduction

Every company at some point needs to increase its share capital. When it decides to increase its capital, speed and fewer procedural requirements are two factors which are always of concern. This becomes even more crucial when foreign shareholders are involved and time has to be factored for potentially securing "internal" approvals at various levels for those investments by such foreign shareholders. In addition, wire transfers too can sometime take longer than 48 hours. For Indian shareholders or other persons who wish to subscribe to the shares of a company, these constraints may not necessarily exist. While there are many methods to increase the paid-up capital as discussed below, companies often take recourse to private placement for allotting shares and increasing their capital. Private placements can be made by both private and unlisted public companies in accordance with the provisions of the Companies Act, 2013 ("**2013 Act**"). With the new law under the 2013 Act, the procedure for private placement has become comparatively more structured, time oriented and transparent.

This newsletter discusses the concept and the procedure, timelines, pricing etc. prescribed under the 2013 Act for private placement by private and unlisted public companies. Apart from the 2013 Act, a listed issuer, has to adhere with the SEBI (Disclosure of Investor Protection) Guidelines, 2003. Since these guidelines refer to the 1956 Act and are yet to be updated, the scope of this newsletter is confined to private placements by private and unlisted public companies only and briefly throws light on the loopholes of the private placement provisions under the Companies Act, 1956 ("**1956 Act**"), which the new law curbs.

1. Different kinds of issues

The 2013 Act primarily prescribes four modes of increasing share capital: Public issue, Rights issue, Bonus issue and Private placement. A **Public issue** can either be an initial public offer ("**IPO**") or a follow-up public offer ("**FPO**"). With an IPO, an unlisted public company can make either a fresh issue of securities or offer its existing securities for sale for the first time to the public while an FPO allows an already listed company to make a fresh issue of securities to the public. Both IPO and FPO are governed by stock market regulator, SEBI, and the corresponding laws and regulations. A public or a private company can also increase its share capital base through a **rights issue** where it can issue fresh securities to existing shareholders in a particular ratio depending on the number of securities held prior to the issue. This route is best suited for companies who intend to raise capital without diluting stake of their existing shareholders. Under a **bonus issue**, a company can issue fully paid-up bonus shares to its members out of its free reserves, security premium account or capital redemption reserve. With bonus issues, the total number of issued shares increases *i.e.* to say that the shareholder base of the company increases but, the ratio of number of shares held by each shareholder remains the same. A **private placement of securities** is an offer by a company, to a select group of persons to subscribe its securities.

2. Private placements: Key features

The law for private placement of securities is codified under sections 42 and 62 of the 2013 Act and the Companies (Prospectus and Allotment of Securities) Rules, 2014 ("**Rules**"). Essentially, section 42 and the Rules contain the complete code for private placement. However, rule 13 of the Companies (Shares Capital and Debentures Rules), 2014 prescribes certain mandatory secretarial compliances in case of various modes of issue of shares under section 62 (which, in addition to ESOPs and rights issue by unlisted companies, include private placements too). Therefore, a company making private placements must comply with section 62 of the 2013 Act too.

Offer Procedure

Before initiating private placement, a company must ensure that it's articles of association authorize increase of share capital by private placement. If that's not the case, the first step will be to amend the articles which will involve approvals both at the Board and shareholder levels. If the articles authorize, the company should get the shares valued[1] and take it up in their board meeting. Once the board decides to go ahead with private placement, it must put forth the proposal of increasing the capital through private placement before the shareholders. The shareholders must approve the proposal through a special resolution before a company can proceed with private placement.

Section 42 and the Rules provide that a company proposing to make a private placement cannot propagate the same through advertisements. It mandates companies to issue an offer letter which spells out the terms of offer of securities. Such terms should typically mention the nature of securities on offer, timelines for acceptance of the offer, mode of accepting or rejecting the offer etc. Company can make offers only to such persons whose names are identified prior to the invitation to subscribe[2]. The law makes no distinction between an Indian citizen and a foreign shareholder *i.e.* to say, private placement can be made to any person except for qualified institutional buyers and ESOP holders. Normally, a company would prefer approaching its existing shareholders over any other person. If they do not accept the offer or if the company is not able to raise the required amount of capital from existing shareholders, then it may consider approaching its key managerial personnel, kith and kin of the directors etc.[3] Basically, the underlying element of the provision is that private placements cannot be made to persons who are not even remotely acquainted with the company.

Further, there are fixed timelines for execution. A company must allot the securities within sixty days from the date of receipt of the subscription money and if it cannot do so within that period it must repay the application money with interest. Where the companies fail to adhere with the mandates prescribed under section 42, the directors, promoters and the

[1] Section 42 mandates that a company proposing to issue securities through private placement must, in order to determine the value of the securities on offer, procure a valuation report against those securities from a registered valuer.

[2] The board must record the identified names in their board meeting minutes where the resolution for approving increase in share capital is passed.

[3] This is not what the law provides, but mostly, this is the practice which companies follow at the time of private placement offer.

company shall be liable to bear a penalty up to INR 20 million (USD 327,000)[4] payable within thirty days. The Registrar of Companies[5] takes cognizance of any contravention under sections 42 or 62. While the law is yet to be tested the theoretical penalty is quite prohibitive and should act as a deterrent for companies who would have to ensure due compliances in order to avoid possible complaints by aggrieved persons.

A few other noteworthy points **(a)** the subscription money should be paid through cheque or demand draft or other banking channels and not by cash, **(b)** in order to ensure accountability; companies must maintain separate bank accounts in scheduled banks to keep the subscription money; and **(c)** records of allotments must be reported to the RoC in PAS-4 with 30 days of allotment.

Size of offer

The minimum investment size cannot be less than INR 20,000 (USD 324 INR), per person on the face value of the securities. Further, unlike a public offer where shares are offered to public at large, a private placement can be made to a maximum of 200 people (*and not mare than 50 people per offer*) in a financial year. This number excludes qualified institutional buyers such as banks, financial institutions etc. and employees of the company to whom shares are allotted under ESOPs.

A classic case of menace under this provision is the Sahara scam.[6] In the case of Sahara scam, two unlisted companies, Sahara Real Estate Corporation Ltd. and Sahara Housing Investment Corporation Limited in the garb of private placement, issued optionally fully convertible debentures and raised approximately 3,243 million USD from the public. The two companies made private placements in multiples of 49 (in-line with the 1956 Act) and in essence, made a public issue through private placement! The Sahara lawyers contended that there is no prescribed limit for number of persons to who private placement offers can be made. They also argued that they complied with the 1956 Act as the company had made offer to only close friends and relatives of the promoters and directors. Moreover, as unlisted companies they were not required to issue prospectus and make disclosures. The Supreme Court looked into the spirit of section 67 of the 1956 Act and interpreted it to hold that although the intention of the companies was to make the issue of debentures look like a private placement, it ceases to be so when the securities are offered to more than 50 persons and, hence, qualifies to be a public offer.

Conclusion

From companies' standpoint, there are enough reasons why private placements are preferred over a rights or a bonus issue. In the latter, a company can issue only "shares," whereas in a private placement, it can issue "securities" i.e. shares, debentures and even hybrid

[4] The exchange rate is 1$= INR 61.
[5] The RoC office has adjudication officers appointed by the Ministry of Corporate Affairs and they adjudge penalty provisions under the 2013 Act.
[6] There was a similar provision to section 42 under the corresponding section 67 of the 1956 Act too.

Disclaimer – This e-newsline is for information purposes and should not be construed as legal advice. © PSA

instruments like compulsorily convertible debentures.[7] Further, they can issue shares to persons other than shareholders too.

The provisions under the new law are pro-investor. Fixed timelines for share allotment and levy of interest on late refund of subscription money with interest are some good steps towards safeguarding investors' interests. Companies cannot now promise share allotment, collect money from interested investors and then delay allotment and issue of share certificates. In order to ensure that private placements stay private, the 2013 Act clearly prohibits advertisements. As a result, unlike the practices under the 1956 Act, companies cannot now utilize media, marketing channels, services of agents and brokers or other distribution channels to make a private placement. The mandate for maintaining separate bank accounts has introduced transparency and accountability. Further, with high quantum of penalty for violation of section 42 and detailed provisions, let's hope for no instance of mis-interpretation by the companies!

Author:
Mansi Airi Gambhir

[7] In the case of Sahara scam, the Sahara lawyers argued that section 67 of the 1956 Act included shares and debentures under its scope. As optionally fully convertible debentures were hybrid instruments, they do not qualify to be "securities" under the SEBI Act. Therefore, Sahara was never required to adhere with the disclosure requirements, pricing guidelines etc. required in case of a public offer. The provisions under the 2013 Act ensure that no such contention is ever made.

Disclaimer – This e-newsline is for information purposes and should not be construed as legal advice. © PSA