Rights Issue – A New Paradigm

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A Rights Issue is a subscription right offered to company's existing security holders to buy additional securities in the company. It is an offering made to existing security holders in proportion to their existing holding. Thus a rights issue of equity share in a public company is a non-dilutive way to raise equity capital. Rights issue of equity shares offset the dilutive effect of issuing more shares. The shareholders who are offered equity shares may or may not subscribe to the same. They may subscribe to their entitlement partly or fully. Not participating or partly participating in a rights issue will however dilute their overall stake in the company. Rights issue also allow shareholders to buy additional shares beyond their right entitlement, if those additional shares are available. Companies often offer shares in a rights issue at a discount to the market price.

Board of directors of the company decides the issue schedule, record date, price, number of shares, pro-rata entitlement and other terms and conditions of the rights issue. An inherent right of a shareholder in a rights issue is the right to renounce to any other person, whether shareholder or otherwise. Renunciation of rights shares can be made fully or partly in favour of any person.

Rights issues are typically sold via an offer document at a specified price within a subscription period. In India, the rights issue framework is guided by provisions of Companies Act, 2013, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, FEMA (Non-Debt Instruments) Rules, 2019 and sector specific regulations as may be applicable to the company.

Rights issue framework has kept pace with the changing requirement of securities market in India. Concepts such fast track rights issue, which do not require vetting of offer document by SEBI, abridged disclosures in offer document for companies with good corporate governance practices, compulsory ASBA as mode of payment, faster listings etc have been successfully implemented in the past, thereby making the rights issue timelines and processes efficient. This benefitted the corporate sector and its stakeholders immensely. However the rights process continued to be paper driven. The application process and renunciation process were largely manual while the evolving environment was technology driven. Rights entitlements were intimated to shareholders through composite application form ("CAF"). Rights entitlement was overprinted in the CAF based on rights ratio and dispatched to shareholders. This process of printing and dispatch was costly, onerous and many shareholders did not get the forms on time. CAF was also a complex application form with Parts A, B, C and D to be filled up depending on whether the shareholders was subscribing, renouncing, partly renouncing etc. To add to the complexity, shareholders wanting to partially renounce had to request for split forms. The trading of rights entitlement on stock exchange was settled physically, resulting in low liquidity and low transparency. All of the above lengthened the time from date of rights announcement till listing of rights equity shares resulting in higher price risk.

To overcome the above challenges, SEBI prudently introduced in January 2020, dematerialization of rights entitlements under a separate ISIN ("RE") to be credited to shareholders' demat account and simplification of application process. The shareholder could now use such dematerialized RE for applying in the rights issue or renouncement, either full or in part. The need to request split forms was done away with and overprinting of CAFs was not required. This enabled replacement of the erstwhile complex CAF with a common application form to its shareholders as on the record date. Along with application form, the issuer would send the details of the rights entitlements of the shareholder separately. This application form could be used both by shareholder or renouncee. Registrar to the issue would upload the application forms on its website for easy access. The depositories will suspend the ISIN of REs for transfers, from issue closing date and REs which are neither renounced nor subscribed by the shareholders, shall lapse after closure of the Rights Issue. Once allotment is done, the ISIN for REs is permanently deactivated in the depository system by the depositories. The checks and balances were to ensure there is no misuse and every action could get audited and verified.

An added advantage was electronic trading and settlement of RE on stock exchanges resulting in better price discovery and transparency. The ensuing reduction in timelines released liquidity quickly in the hands of both the company and shareholders. It also encouraged those shareholders who are still holding shares in the physical form to opt for dematerialization as the REs are allotted electronically only.

This process is new and was successfully tested for the first time in May 2020 for mega rights issue of Reliance Industries Ltd. It was the first company to credit the rights entitlement of its shareholders directly to their demat accounts so they can trade them on the exchange platform. There are a bunch of rights offerings in July

2020 which will also follow this process. Trading in REs on the secondary market platform of stock exchanges shall commence along with the opening of the issue and shall be closed at least four days prior to the closure of the rights issue. This will ensure that shareholders and the renouncee have sufficient time to subscribe to the issue.

This process and platform gives shareholders an opportunity to gain some value of eligible RE shares. Until now, shareholders, who didn't wish to apply, had to let their RE lapse or had to transfer it for free. By introducing this platform shareholders can see intrinsic value of right shares. It is expected that introduction of RE trading will allow retail shareholders to more easily participate in rights offers. They can purchase additional rights shares, sell or renounce their shares thru the stock exchange online and directly. Trading on the exchange will be on T+2 rolling settlement basis. However intra-day trading in RE is not possible. Off-market transfer will be settled by transferring dematerialised REs through the depository mechanism. When there is a Non-resident as one of the counter parties to RE trading, care should be taken to comply with requirements of FEMA (Non-Debt Instruments) Rules, 2019. Certain Non-residents cannot trade off market while certain can. When trading off market the transaction price has to comply with that prescribed under FEMA Rules. While there is scope to liberalise this aspect of rights issue, it falls outside the scope of SEBI.

In conclusion, the simplification of the process will reduce the timelines for right issues and provide transparency on the renunciation and trading of rights entitlements. These steps are welcome and will potentially make rights issues a preferred option to raise capital for listed companies and will greatly benefit shareholders and corporates.