Post-Listing Special Rights of the Pre-IPO Shareholders

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Introduction to special rights:

In the pursuit of obtaining private equity/ strategic investments for a company prior to its initial public offering ("**IPO**"), strategic measures are employed, wherein the company extends special rights to its pre-IPO investors. These specialised entitlements find their formal expression within Shareholders' Agreements ("**SHAs**") that are executed between the company and its pre-IPO investors or promoters/ founders, and as well as the Articles of Association of the company ("**AoA**"). By articulating these rights, companies establish a clear framework, and defines relationships with their pre-IPO investors and promoters/ founders. These special rights play an important role in attracting investments by offering added benefits and protection to pre-IPO investors and promoters/ founders and exits in case of liquidity events such as IPOs.

The spectrum of these distinctive rights exhibits considerable variation among companies, as they are contingent upon the specific requirements articulated by the respective investor, promoter, or founder. Noteworthy among these privileges are as follows:

(i) Nomination rights, which empower the investor or promoter or founder to nominate individuals for pivotal positions within the company.

(ii) Veto rights, or alternatively known as affirmative voting, endow the investor or promoter or founder with the authority to exercise a veto or grant consent with regard to significant matters.

(iii) Information rights entail access to pertinent company information, ensuring transparency, facilitating well-informed decision-making, and monitoring the investee company's performance.

(iv) Anti-dilution rights, which serve as safeguards against the dilution of the investor's or promoter's/ founder's ownership stake in case of subsequent funding rounds.

(v) Divestment rights, which furnish the investor or promoter or founder with the prerogative to divest their investment under specific circumstances.

(vi) *Inter se* share transfer restrictions, including, such as –

   (a) The right of first refusal conferring upon the investor or promoter or founder the initial opportunity to acquire additional shares by either accepting or refusing an offer from a selling shareholder after the selling shareholder has received a third party offer for its shares.

   (b) The right of first offer providing the investor or promoter or founder with the right to make an offer for the selling shareholder's shares before the selling shareholder can solicit for third party offers for its shares.

   (c) Tag along rights or co-sale rights allowing the investor or promoter or founder to partake in the sale or acquisition of shares alongside majority shareholders.

   (d) Drag along rights allowing a majority shareholder to force a minority shareholder to participate in the sale or acquisition of shares alongside majority shareholders.

In the subsequent sections, we will delve into an overview of the treatment of existing special rights during an IPO in India. Furthermore, we will discuss the latest advancements in this area, notably the obligatory periodic approval of special rights in listed companies, as well as the disclosure obligations pertaining to material agreements, encompassing *inter se* agreements and the Shareholders' Agreements (SHAs), in the context of listed companies in India.

Special rights in IPO bound companies:

Regarding special rights in listed companies, it is worth noting that investment protection rights or governance rights are now widely recognized as separate from control in the context of a listed company. Consequently, it is not uncommon to encounter such rights within a listed company's Shareholders' Agreements (SHAs) or Articles of Association (AoA). While listed companies are permitted to possess a wider range of special rights, the regulatory standards applicable to IPO companies necessitate a certain level of parity between existing shares and shares to be issued or allotted during the IPO process. Accordingly, pre-IPO special rights are typically required to be terminated prior to the company's listing.

While special rights give protection and participation to an investor till a company is well established in scale and size, it becomes necessary to reassess these rights when the company considers going for an IPO. This re-evaluation is driven by regulatory expectations that aim to ensure equity between IPO and post-IPO shareholders by eliminating certain privileges. Historically, the expectation was that all rights would terminate upon listing, with only nomination rights, and occasionally information rights, surviving subject to post-IPO shareholder approval. However, in recent times, Securities and Exchange Board of India ("**SEBI**") has adopted a different perspective regarding the inclusion of special rights, expressing dissatisfaction with any form of such rights in the Articles of Association (AoA) of a company seeking an IPO. Furthermore, recent position suggests termination of all special rights before filing the red herring prospectus, with a few exceptions made for nominees who are allowed to complete their existing term. It is important to note that this stance does not stem directly from a change in regulations but is based on SEBI's recent observations on specific ongoing transactions. Consequently, there has been a rise in unpredictability concerning the continuation of basic special rights, even until the listing stage. In certain cases where deals are at an advanced stage, companies are compelled to terminate all special rights before filing the red herring prospectus. In other instances, companies are grappling with the implications of these observations, exploring different scenarios and combinations.

The legal framework applicable to companies going for an IPO, the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, requires an issuer to provide a statement in the offer documents that the shares allotted in the IPO will be equal in all respects, including dividends, with the existing shares issued by the company prior to the public issue, excluding SR (Superior Rights) equity shares. This the closest legal provision requiring a clean-up of the special rights during the listing process.

(i) Special rights (particularly nomination rights) rights provide a valuable advantage to public shareholders by enabling them to have the presence of experienced and knowledgeable investor nominees who bring significant expertise to the boardroom discussions. These mature and long-term investor nominees possess a high calibre of skills and knowledge that can greatly contribute to the decision-making processes within the company. Their participation in company's management adds value by offering unique perspectives, strategic insights, and informed guidance.

(ii) While same class shares of a listed entity may possess equal rights, it is important to acknowledge that shareholders themselves are not always on equal footing. Promoter shareholders differ from other public shareholders due to additional regulatory and contractual obligations they bear, including:

(a) Liability in case of misstatement in prospectus: Promoters carry the liability for any misstatements or omissions in the prospectus.

(b) Promoter contribution requirement: Promoters are typically required to bring in the minimum promoter's contribution, which requires them to hold 20% of the post-IPO capital of the company which is locked-in for a period of 18 months to three years from the IPO.

(c) Exit option for dissenting shareholders: In case of a change in the objects of an IPO, promoters are obligated to provide an exit option to dissenting shareholders.

(d) Ongoing regulatory obligations: Promoters are subject to various regulatory obligations, including maintaining minimum public shareholding levels and fulfilling reporting requirements.

(e) Contractual obligations in capital markets transactions: Promoters often have contractual obligations arising from IPO.

These additional regulatory obligations and contractual commitments are partially offset by the special rights that promoters can continue to enjoy after the listing. Moreover, it is worth noting that in the case of numerous companies, particularly those in the new-age technology sector, significant dilution in funding rounds leading up to an IPO has resulted in founders holding only a negligible stake in the company. In some situations, despite holding slightly above 10% of the shareholding, these founders are urged by regulators to be recognised as promoters. However, they lack the necessary voting power to pass resolutions through their own votes. In light of this situation, special rights such as nomination rights are of great importance for these founders/promoters, as they possess invaluable know-how and have painstakingly built the company's business from the ground up.

(iii) In the present business environment, it is not uncommon to find companies with private equity or private equity-backed promoters. For these entities, the designation of being a promoter of a listed company holds significant commercial relevance, often tied to specific structures and accompanied by special rights. However, if the ability to retain these special rights after the listing process is limited, it could potentially deter foreign investors from engaging in the Indian market.

Following the recent amendment to the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**Listing Regulations**"), which is discussed below, it is evident that inclusion of special rights is allowed in the Shareholders' Agreements (SHAs) and Articles of Association (AoA) of listed companies, provided they receive shareholder approval. However, the same dispensation has not been extended to "to-be-listed" companies without any apparent justification. There seems to be a lack of rational connection between the treatment of listed and "to-be-listed" companies in this regard. Furthermore, the insistence to terminate special rights at the time of filing the red herring prospectus (which was previously required before listing), with only limited exceptions granted for nominees to complete their existing terms, is undeniably stringent. It is important to note that the filing of red herring prospectus is still approximately two weeks away from the deal's completion, and even then, it does not guarantee the occurrence of the deal.

Periodic approval of special rights in listed companies:

In a recent consultation paper on regulatory reforms pertaining to special rights, SEBI highlighted two key observations. Firstly, SEBI noted that the voting patterns of certain companies, particularly those in the new-age tech sector, which recently underwent the listing process, indicated concerns raised by public institutional shareholders regarding the conferment of specific special rights to promoters, founders, or certain corporate bodies associated with the founders.

Secondly, SEBI pointed out that in some of these companies, the prevailing practice was to allow these shareholders to enjoy special rights indefinitely, regardless of their shareholdings, which is against the principle of rights being proportional to one's holding in a company and the requirement under the Listing Regulations for the listed companies to ensure equitable treatment of all shareholders.

In India, promoters, or founders of certain categories of to-be-listed companies are allowed to receive Superior Voting Rights (SR) shares, which have a maximum validity period of 10 years after listing. To ensure that special rights do not continue indefinitely, SEBI deemed it appropriate to introduce a periodic approval mechanism for special rights every five years, subject to shareholders' consent. Additionally, the existing special rights are now required to be ratified with shareholders' approval. These regulatory changes have been implemented through the inclusion of Regulation 31B in the Listing Regulations.

The conditions for obtaining periodic approval of special rights are as follows:

(i) Any special right granted to a shareholder of a listed company is subject to receiving approval from shareholders through a special resolution in a general meeting once every five years, starting from the date of granting such special right; and

(ii) Existing special rights that are already in place for any shareholder of the listed company is subject to obtaining approval from shareholders through a special resolution within a five-year period from July 14, 2023, which is the date on which Regulation 31B of the Listing Regulations came into effect.

Special rights under lending arrangements and debenture subscription agreements:

Special rights granted to financial institutions regulated by the Reserve Bank of India or to debenture trustees registered with SEBI, as part of lending arrangements or subscription agreements for debentures issued by a listed company, fall outside the scope of the regulations governing special rights applicable to shareholders of a listed company. Furthermore, even if a lending institution or a debenture trustee becomes a shareholder of a listed company as a result of lending arrangements or subscription agreements for debentures and subsequently enjoys specific special rights within the listed company, they are exempted from the requirement of obtaining periodic approval from shareholders as outlined in Regulation 31B of the Listing Regulations.

Disclosure of Shareholders Agreements (SHAs) and inter se agreements in listed companies:

As per recent changes to the Listing Regulations, agreements such as *inter se* agreements, or SHAs (irrespective of their inclusion in AoA), among others, which have an impact or potential impact or whose purpose is to impact the management or control of the listed company, or impose restrictions, liabilities, or obligations on the listed company, are required to be disclosed to the stock exchanges. In addition, even if the listed company is not a party to such agreements, agreements entered by certain persons (as specified in the table below) among themselves or with the listed company or a third party, either individually or collectively, are required to be disclosed. Furthermore, any rescission, amendment, or alteration to such agreements are also required to be disclosed. These changes have been implemented by introducing Regulation 30A, clause 5A to paragraph A under Part A of Schedule III, and paragraph (G) under Schedule V in the Listing Regulations.

The following are the disclosure requirements for the aforementioned agreements:

Parameter	Future agreements	Existing and subsisting agreements
Parties to the agreement	Shareholders, promoters, promoter group entities, related parties, directors, key managerial personnel and employees of a listed company or of its holding, subsidiary and associate company.	Shareholders, promoters, promoter group entities, related parties, directors, key managerial personnel and employees of a listed company or of its holding, subsidiary and associate company.
Timeline to inform the listed company if it is not a party to the agreement	Within two working days of entering into such agreements or signing an agreement to enter into such agreements.	Within the timelines to be specified by SEBI in this regard.
Disclosure to stock exchanges under Regulation 30 of the Listing Regulations by the listed company	Within 12 hours of signing of the agreement or approval to sign the agreement if the listed entity is a party to the agreement, and 24 hours if the listed entity is not a party to the agreement.	Within the timelines to be specified by SEBI in this regard.

Disclosure in the annual report	Yes, these are required to be disclosed in the annual reports, with effect from July 14, 2023.	An executive summary of such agreements, including the number of agreements and the salient features, will be disclosed in the Annual Report for FY 2022-23 or FY 2023-24 along with a link to the exact webpage where the complete details are available (if companies are unable to disclose the executive summary in the Annual Report of FY 2022-23, the same will be disclosed in the next financial year i.e., FY 2023-24).

Furthermore, agreements entered into by a listed company in the normal course of business are not required to be disclosed unless they have an effect on the management or control of the listed company, or they are required to be disclosed in terms of any other provisions of the Listing Regulations.

Uncertainty of special rights:

The granting of special rights in a company entails the delicate task of managing various stakeholders' expectations while establishing a framework for the involvement of promoters, founders, and investors in the company's governance. A stable and predictable environment for special rights is necessary to foster investor confidence and encourage meaningful engagement in the company's governance. However, the availability and certainty of basic special rights, such as nomination rights and information rights, have become increasingly uncertain for companies pursuing an IPO or those already listed. This uncertainty poses challenges for investors who rely on such rights to make long-term strategic decisions.

Furthermore, the requirement for periodic ratification of these rights introduces the risk of losing them, which may disincentivize investors. Special rights are typically perceived as essential for enabling investors' strategic involvement, and their loss can diminish the value of investor protection measures.

In light of these considerations, it is important to carefully navigate the complexities surrounding special rights. Striking a balance that safeguards investor interests while ensuring transparency and accountability is a crucial aspect that needs to be addressed.
