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Pricing guidelines fortified in case of rights issue

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It is well said that "A ship in the port is safe, but that is not what ships are built for". While the pandemic did pause the international M&A and capital movement, however, the biggest of deal announcements in the recent times are clear indications that the ships have left the safe harbour to weather the storm and catch the bounty!

A seismic shift is expected in the World order and more specifically, the news of more and more companies planning to move base out of China is making rounds every day. India, over the years, have made significant strides to make itself an attractive investment destination and has thrown it's hat in the ring at this opportunity which has presented itself. However, the socio-economic structure of the country warrants that we continue with the protectionist stance. Though the most ardent apostle of open markets and free economy will also agree that the protectionism is quite mellowed, compared to early nineties when India first opened it's door for foreign investment.

About four weeks ago we saw change in FDI regulations - prior Government approval was made mandatory for foreign investments from countries that share land border with India to curb "opportunistic takeovers" of domestic firms following the Covid-19 pandemic, a move which was clearly aimed at restricting Chinese companies making such a ploy. More recently, there was a change in the pricing guidelines, wherein this has been made applicable on rights issue as well, if renounced in favour of a non-resident. Let's understand this a little better:

One of the key attributes of regulating the inflow and outflow of foreign capital under exchange control regulations has been the pricing guidelines for acquisition and disposal of Indian shares by non-residents. While the methodology and mechanics of the valuation requirement have changed and quite honestly evolved, the basic premise has remained the same. That being non-residents cannot acquire the shares of an Indian company (*i.e.* purchase from a resident or subscribe to a fresh issue) at a price lower than a floor price and cannot sell to a resident at a price higher than a ceiling. However, these pricing guidelines were not applicable on rights issue (as long as the issue price was not lower than it was for residents in case of unlisted shares), and this was so for a very good reason. Rights issue is where shares are offered by a company to its existing shareholders in proportion to their existing holding. Hence, by the very nature of the issue, it contemplates no redistribution or change of shareholding ratio, which means that the price at which the rights issue is being made is

irrelevant. In the company law also, there is no pricing requirement is case of rights issue. Interestingly, even tax laws take cognizance of the concept of rights issue (though ever reluctantly so, as this is a principle emerging out of judicial interpretation and not in the express law).

However, it is pertinent to note that the rights issue under company law also provides an opportunity to existing shareholders to renounce the offer in favour of third parties. The company law or the FDI regulations does not carve out an exception when such renunciation happens. Meaning thereby that the (prior to the change on 27 April 2020) pricing guidelines under FDI regulations effectively did not apply for rights issue, even where there was an acquisition made by non-residents pursuant to renouncement by a resident (of his portion of the rights offer) in favour of such non-resident.

Given the lack of an express prohibition, there have been instances where Indian companies 'staged a rights issue' and existing resident shareholders have renounced their rights offer in favour of non-residents enabling them to make substantial investments in Indian companies which are not in proportion of their existing holding, at a price lower than what the pricing guidelines prescribe. On the other hand, had it been a preferential issue (issue of further shares which are not to the existing shareholders in the proportion of their existing holdings), the non-residents would have to acquire the shares at a price not lower than price determined under the pricing guidelines.

To curb this malpractice, the FDI regulations have been amended and has now prescribed that in case non-residents intend to acquire shares pursuant to a right offer renunciation by a resident in their favour, the price of such securities cannot be lower than the floor price determined under the pricing guidelines. This may not really qualify as a retrograde step, as it is only meant to plug a loophole. Rights issue were never meant to provide one set of shareholders any advantage over other. It was an equitable offer to subscribe to further capital of the company, hence the concept of floor price for non-residents was made inapplicable. It was only the unscrupulous exploitation of these provisions, by dressing up what essentially was a preferential issue as a rights issue, for the purpose of avoiding the regulatory rigors applicable on a preferential issue, which is intended to be curbed by this amendment.

However, from an income tax perspective, the aspect of pricing of shares had been clearly spelt out since a while now. Foreign investors subscribing to shares in any Indian company, at lower than the prescriptive floor price (methodology to determine this floor price is different in tax laws than what is prescribed in the FDI regulations) would have had undesired consequences on their hands. Though the applicability of this anti-abuse provision on non-resident investors has been a debatable issue in itself. Further, renunciation of rights offer can itself potentially result in tax incidence in the hands of transferor and transferee.

The amendment in the FDI regulations intends to ensure that acquisition by non-residents pursuant to renunciation (of right offer) by residents are fairly priced and based on same methodology as been prescribed for other issues like preferential issue and IPO.

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