

Differential Voting Rights – A Struggle For Power

written by Rajashree Devchoudhury | September 4, 2019

One's power to control

and rule in a democratic set-up is entwined with the system of voting and rights. In recent times, India has witnessed the emergence of several start-ups

in various sectors and the struggle for controlling these start-ups is like a sword

hanging over the founders' neck. In order to grow and endure the competition in

today's world, these start-ups require capital. However, the process of raising

capital is always followed by a fear of losing control over the management of the company by giving away one's equity in the company.

Recent trends in the

global corporate sphere have led to the emergence of various instruments and strategies which enable the raising of capital without diluting the founders' control over the management of the company. The Securities and Exchange Board of India ("SEBI") has approved the issuance of

Differential Voting Rights ("DVR") Shares. Consequently, the amendments made to

the Companies Act, 2013 ("Act")

and its rules have consolidated the law relating to the issuance of DVR Shares.

Brief History: Differential Voting Rights Shares were introduced in India for the first time in the year 2000, vide an amendment in then Companies Act. It was one of the most discussed amendments in the world of corporate governance in India, as it altered the archaic practice of 'one vote for one share'.

What

are DVR Shares?: Unlike conventional equity shares, DVR

shares are a genre of equity shares with either superior or fractional voting rights. Superior Right ("SR")

Shares offer multiple voting rights against one share, whereas Fractional Right

("FR") Shares offer lesser or a

fraction of voting rights against one share. In lieu of the fewer voting rights, FR Shares may offer higher dividends when compared with the regular equity shares.

Current

Legal Provisions: Section 43(a)(ii) of the Companies

Act, 2013 read with Rule 4 of the Companies (Share Capital and Debentures)

Rules, 2014 ("Rules") empowers

a company to issue equity shares with differential rights, which is a part of the total share capital of the company as well. The nature of rights appended to such equity shares (viz. DVR Share) may either be pertaining to dividend, voting or otherwise. DVR Shares may be issued by a company in accordance with the Rules provided that the Articles of Association of the company allowing the

issuance of DVR Shares.

Recent

Amendments: The Ministry of Corporate Affairs

("MCA") had consulted the Primary Market Advisory Committee ("PMAC") and sought opinion from the general public. Consequently, on the recommendations made by PMAC and the comments received from various stakeholders, the MCA on August 16, 2019 amended the provisions of the Act pertaining to the issuance of DVR Shares. Some of the key modifications and features following the amendments are listed herein below:

- The previously existing cap for issuance of DVR Shares of 26% has been raised to 74% of the total issued paid-up equity share capital which shall include voting powers of equity shares with differential voting rights issued at any point in time^[1].
- The requirement of a company to have a consistent track record of distributable profits for the previous 3 years, prior to issuance of DVR Shares has been done with^[2].

The aforementioned amendments have been made in consonance with the opinions and comments received and the same has been made with the intent of preventing a hostile takeover of start-ups and tech companies. These changes have been brought about with an intent to ease the process of raising capital without losing control of the company by its founders.

SEBI

guidelines and framework for issuance of DVR Shares:

SEBI, vide its press release dated June 27, 2019, approved a framework for issuance of DVR Shares. The key proposals approved by SEBI are listed below:

1. The Initial Public

Offer ("IPO") made by a company having SR shares must be in compliance with the eligibility requirements of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ("Regulations"). In addition to the IPO of such companies such requirements shall only be applicable with respect to ordinary equity shares. The issuing company should be a company involving science, technology and innovation. Further, SR shareholders of the issuing company should mandatorily be a part of

the promoter group and also, they should hold executive positions in the company. It is pertinent to mention here that such shareholders should not have

a combined net worth exceeding Rs.500 Crores. For the purpose of determining the collective net worth, the investment of the shareholders of SR Shares in the issuing company shall not be taken into consideration. A special resolution

by the members of the company authorising such issuance is mandatory and the SR

Shares must be held for a minimum period of 6 months prior to the filing of Red

Herring Prospectus. Further, the voting rights attributed to the SR Shares may

vary from a minimum of 2:1 to a maximum of 10:1, as compared to the ordinary equity shares of the company.

2. Even though, SEBI

mandates the listing of SR Shares subsequent to public issue of its ordinary equity shares, restriction in the form a lock-in on the SR Shares has been imposed until the SR Shares are converted into ordinary shares. In view of the

lock-in, the SR Shares are non-transferable even among the promoters and no encumbrance, either in the form of a pledge or a lien can be created over the SR Shares.

3. Other than voting

on resolutions, the SR shareholders shall be treated at par with the ordinary equity shareholders in every respect (including dividends). The significant proposal which led to the amendment of the Act is the rise in the cap of the total DVR shareholding from 26% to 74% of the total share capital of the company.

4. Companies having SR

shareholders shall mandatorily have independent directors constituting a minimum of half the board of directors and two-third of the committees, as stipulated under SEBI (LODR) Regulations, 2015. Further, the audit committee shall mandatorily be comprised only of independent directors.

5. Subsequent to the

IPO, in so far as, appointment or removal of independent director / auditor, transfer of control to another entity, related party transaction involving SR shareholders, voluntary winding up, changes to the Memorandum or Articles of Association (except any changes affecting the SR instruments), initiation of voluntary resolution plan under IBC, utilisation of funds for purposes other than business, substantial value transaction based on materiality threshold, passing of special resolutions pertaining to delisting or buy-back of shares and any other provision as may be notified by SEBI, the SR Shares shall be deemed to have voting rights at par with the ordinary equity shares, viz. one vote one share.

6. As per the

guidelines and framework, ordinarily the SR Shares shall be converted to ordinary equity shares in the fifth year from the date of listing. However, the

time period for conversion can be extended for a further period of 5 years through a resolution to that effect and only one such extension would be permissible. The SR Shareholders shall not participate or have voting rights on

such resolutions. Further, the SR Shares shall compulsorily get converted to ordinary equity shares in the event of demise, the resignation of SR Shareholders, merger or acquisition and any event which would lead to the control no longer vesting with the SR Shareholder.

7. FR Shares: At

present there is a total prohibition on the issuance of FR Shares by listed companies subject to review by SEBI in the future.

Salient

features and advantages of DVR Shares:

Prevention of hostile

take-over: The foremost purpose of the amendment of the Act

is to ensure that tech start-up companies having innovative and unique ideas are not forcibly taken over by big investors in the market. DVR Shares provides

for an opportunity to the promoters/founders of a company to raise capital without fearing of dilution of their equity rights in the company. DVR Shares,

thus, prevents hostile takeover and provides comfort to the founders to raise higher capital while still retaining majority equity voting rights.

Strategic Investments:

DVR Shares provide an opportunity for investors to reap the benefits of a high

- growth business venture, without being dragged into the day-to-day affairs of

the company.

Better dividends:

DVR Shares generally offer higher returns in lieu of surrendering voting rights.

Conclusion:

The recent amendment to the Act and the guidelines and frameworks issued by SEBI go a long way in ensuring the growth of entrepreneurship and innovations.

The small start-ups and their endeavours are prevented from being nipped at the

bud. The enhancement in the cap of voting rights will lead to infusion of capital into the companies without compromising on the management and ideals of

the founders of the company. Fair-trade and competition will also be promoted on account of the prevention of hostile takeovers which ultimately lead to monopoly. The recent amendment is a welcome step towards ensuring the secure growth of start-up industries and companies in India.

-
- [1] The newly substituted Rule 4(1)(c) shall read as *"the voting power in respect of shares with differential rights of the company shall not exceed seventy four per cent. of total voting power including voting power in respect of equity shares with differential rights issued at any point of time;"*
 - [2] Rule 4(1)(d) has been omitted.

Contributed By - Rajashree Devchoudhury

Designation - Senior Associate

King Stubb & Kasiva,

Advocates & Attorneys

[Click Here to Get in Touch](#)

New Delhi | Mumbai | Bangalore | Chennai | Hyderabad | Kochi

Tel: +91 11 41032969 | Email: info@ksandk.com