SEBI PUTS SELLING SHAREHOLDERS ON SILENT MODE: DO SHAREHOLDERS' AGREEMENTS NEED A RELOOK?

1. INTRODUCTION

The Securities and Exchange Board of India ("**SEBI**") has recently started issuing observations to Initial Public Offering ("**IPO**") bound companies to ensure that the disclosures in their offer document for decisions with respect to 'offer price' and 'price band', are made in compliance with Part VII of Chapter II of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ("**ICDR Regulations**").[1] These observations stem from the market regulator's recent endeavour to curb the influence of Private Equity ("**PE**"), Venture Capital ("**VC**") and other selling shareholders (collectively with PE and VC the "**Selling Shareholders**") who intend to offload shares in the IPO.

The observations have been made by SEBI on draft offer documents which typically provide that certain decisions in relation to the IPO, including the price band, will be decided by the company and Selling Shareholders in consultation with book running lead managers of the IPO, i.e., granting decision making rights to the Selling Shareholders with respect to the IPO price. This move seems driven by an inclination to prevent the Selling Shareholders from influencing IPO pricing and subsequently affecting IPO performance considering the spate of underperformed tech IPOs, where SEBI seems to be assuming that such Selling Shareholders prioritise the maximisation of their return on investment, by pushing for a higher price, which impacts the broader interest of the IPO-bound company or the interest of the new incoming public investors.

2. LAW RELATED TO PRICING OF IPO

ICDR Regulations define an 'IPO' to mean an offer of specified securities by an unlisted issuer to the public for subscription and includes an offer for sale of specified securities to the public by any existing holders of such specified securities in an unlisted issuer.[2] The Selling Shareholders want to be involved in the IPO process because in most scenarios they are offering their shares for sale in the IPO through the offer for sale component. As a result, they are keen to actively participate in the IPO process, particularly in determining the share price, as their return-on-investment hinges on this pivotal decision. Even in instances where they might not be participating in the IPO, they might still want to have some say given that an IPO is an important valuation benchmarking event for the company.

As per Regulation 28(1) of ICDR Regulations, the determination of the IPO price is vested in the issuer, in consultation with the lead managers or through the book-building process, depending on the circumstances. In this context, the term 'issuer' has been defined in the ICDR Regulations to mean a company or a body corporate authorized to issue specified securities and whose securities are being issued and/or offered for sale.[3] Therefore, it is the company going for the IPO which has to decide the pricing of

[1] Part VII: Pricing, Chapter II - Initial Public Offer on Main Board of the ICDR Regulations.
[2] Regulation 2(w) of the ICDR Regulations.
[3] Regulation 2(aa) of the ICDR Regulations.

securities and there is no explicit obligation to engage the Selling Shareholders in the decision-making process for setting the IPO price.

It is pertinent to note that in the repealed SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009, ("**Old Regulations**"), the term 'issuer' was defined as any person making an offer of specified securities,[4] therefore being wide enough to include within its ambit the Selling Shareholders as they offer their shares in the IPO through the offer for sale component. However, this definition was modified in the ICDR Regulations because SEBI perceived that the disclosures in the offer document irrespective of primary or secondary issue, are made by the company whose securities are being listed. This updated definition thereby gave SEBI backing under law to make the observation to exclude Selling Shareholders from the price determination process.

However, it is noteworthy that there is no explicit prohibition preventing the Selling Shareholders from participating in this price determination process and in most cases, prior to when these observations started coming from SEBI, one way or another, i.e., through representation on board, shareholding percentage or through a contractual right, Selling Shareholders would almost always manage to get a say in the decision-making when it came to pricing and other important terms in relation to the IPO.

The most common way for a Selling Shareholder to achieve this influence is (i) through contractual rights under the Shareholders Agreement ("**SHA**"), and (ii) through its nominee directors on the board of a company. A nominee director remains bound by their fiduciary duty to act in the best interests of the company (and not just a particular shareholder) in accordance with Section 166 of the Companies Act, 2013 ("**Companies Act**"). Such a conflict may only be resolved where a director recuses himself on account of potential conflict or takes the argument that the interests of the company as a whole and the Selling Shareholders are aligned in relation to the relevant decision.[5]

While the law is clear that the director should work in the best interests of the company, its employees, the shareholders, the community and for the protection of environment, and that the company interest will prevail over their nominator's interest, SEBI's recent observations goes to show their apprehensiveness, in so far as such observations do not even allow the Selling Shareholders to indirectly be involved in decision making, including through their nominee directors in the IPO committee.

One could argue that such observations stand contrary to the ICDR Regulations which mandate that the issuer shall determine the IPO price, as the issuer being a company or body corporate will have to act through its board of directors or a duly constituted committee of the board, i.e., the IPO committee. Even if a nominee director is present in the IPO committee, their obligation under Section 166 of the Companies Act would have ensured a balanced and objective decision-making which would be in the best interest of the company.[6]

3. WHY DO SELLING SHAREHOLDERS PARTICIPATE IN DECISION MAKING?

[4] Regulation 2(r) of the Old Regulations.
[5] AES OPGC Holding (Mauritius) and Ors. vs. Orissa Power Generation Corporation Ltd. and Ors., MANU/CL/0103/2004.
[6] Detailed analysis on duties of directors in India is available here.

The Selling Shareholders who own a large enough stake in a company are often given special rights in the company and serve as long-term financial backers of a company, actively participating, to some extent, in managing and overseeing its operations. Their strategic efforts are of course, geared towards achieving a successful exit and maximizing returns on their investments.

Such Selling Shareholders' interest and their actions as shareholders of the company can be contradistinguished from their appointed nominee directors, as the law allows a shareholder to take a narrower approach and to take actions which will benefit them in their personal capacity even if they may not be in the long-term interests of the company.

In one scenario, Selling Shareholders with a vested interest in their reputation within the IPO market, may exert influence to ensure fair pricing of IPOs for companies they support. While there may be short-term gains from pricing the IPO above its intrinsic value, this strategy carries the risk of long-term losses by significantly tarnishing their standing with IPO investors and other financial market participants. Generally, the understanding prevails that the stronger the reputation of a Selling Shareholder, the greater their motivation to price equity in IPOs closer to its intrinsic value.

On the other hand, the Selling Shareholders who are not worried about their reputation in the IPO market and are not concerned about any long-term impact, may exert influence through their shareholding or contractual rights, to secure a higher IPO price by disregarding the negative consequences it can have on the company or public investors.

These distinct scenarios have profound implications for IPO pricing. The first scenario suggests that the Selling Shareholders are inclined to price IPOs closer to intrinsic value to safeguard their reputation in the IPO market. In contrast, the second scenario indicates that their primary goal is to secure the highest possible IPO price, leveraging their relationships with various market participants. If the mindset of the Selling Shareholders aligns more with the second scenario, the IPO pricing tends to be elevated, potentially impacting the broader interests of the company and post IPO investors, which raises concerns for regulatory bodies like SEBI.[7]

In recent times, these concerns have been solidified primarily due to a cluster of underperforming IPOs, which gave the Selling Shareholders a seat at the table, and are currently trading below their issue price, running the risk of eroding retail investor wealth and confidence.

SEBI in a consultation paper discussed the increasing trend of New Age Technology Companies which do not have a track record or operating profit and have remained loss making pre-IPO, opting to list and the corresponding need to amend relevant regulations to ensure additional disclosures with respect to 'Basis of Issue Price' for such companies as the conventional metric were inadequate.[8] Consequently, SEBI through an amendment to ICDR Regulations,[9] increased scrutiny over issue price by mandating additional disclosures under 'Basis of Issue Price' section of the offer document.[10] It includes disclosure of Key Performance Indicators that were disclosed to pre-IPO investors during the three years preceding the date

[7] Soumya G. Deb, Pradip Banerjee, *Performance of VC/PE-backed IPOs: New Insights from India,* GLOBAL BUSINESS REVIEW, 2020, at 2.
[8] Consultation Paper on Disclosures for 'Basis of Issue Price' section in offer document under SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, para. 3, (2022).
[9] Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Fourth Amendment) Regulations, 2022.
[10] Detailed analysis of the amendment is available here.

of filing of Draft Red Herring Prospectus, among others.[11] This move aims to determine how the valuation of the companies have changed from pre-IPO placement to IPO.

4. DO SHAREHOLDERS' AGREEMENTS REQUIRE A RELOOK?

Under the ICDR Regulations, shares issued in the IPO are required to be at par with existing shares of the company issued prior to the IPO in all respects, including dividend.[12] The underlying principle being that any rights not available to shareholders post listing should not persist for certain pre-IPO shareholders. In light of this, companies preparing for an IPO are required to terminate or modify all existing SHAs to the extent that special rights granted to certain pre-IPO shareholders are terminated before listing. Furthermore, special rights are contingent upon the approval of shareholders in the initial general meeting held after the listing of the company's shares. Subsequently, through an amendment dated June 14, 2023, Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 were revised to stipulate that any special rights granted to shareholders must undergo shareholder approval once every five years.[13]

If SEBI were to impose significant restrictions on the participation of the Selling Shareholders in the pricing of IPOs in the near future, then SHAs would necessitate a thorough re-evaluation, since typically, SHAs of private companies incorporate an exit clause outlining the mechanisms through which the company facilitates exits for investors holding substantial shares in the company, with the gold standard in such exit being through an IPO of the company. In many cases such Selling Shareholders contractually push to obtain rights that grant them control/approval rights over such exit mechanism including but not limited to (i) pricing and size of the IPO, including break-up between primary and secondary component, (ii) appointment of IPO advisors, including book running lead managers, underwriters, bankers and counsels.

In certain cases, SHAs also confer the right to establish a committee exclusively dedicated to the IPO process, comprising of promoters and Selling Shareholders or significant shareholders. These committees then have the power to decide various aspects of the IPO, such as pricing, appointment of advisors/consultants to the IPO and even extending to selection of stock exchanges for listing. Such rights coupled with veto matters essentially bestow upon them the authority to shape every facet of the IPO. SEBI's recent endeavours and observations are therefore divergent from the hard driven ask of investors at the time of pre-IPO issuance to have such extensive rights over pricing and decisions making with respect to an IPO and suggest the need for limitations in this regard.

To address this concern and offer reassurance to investors, whose primary goal is to maximize returns on their investments, SHAs can be structured in a manner that curtails unfettered authority over pricing and other aspects of IPOs, while still granting them visibility and limited role in the process without their active participation in the price determination process. One such strategy could be to limit the investors to a well thought out qualified IPO clause. Customarily, a qualified IPO provision will cover (i) investor discretion in appointment of IPO advisors, (ii) preferred stock exchanges, and (iii) minimum IPO size and valuation. Thus, a company would be in default of its contractual exit obligations unless it delivers an IPO that satisfies baseline investor expectations on liquidity and pricing. Such nuanced restrictions in SHA provisions

[11] Paragraph 9(K)(3)(h)(i), Part A, Schedule VI of the ICDR Regulations.
[12] Paragraph 15(A)(a), Part A, Schedule VI of the ICDR Regulations. This however excludes SR equity shares (SR equity shares are equity shares of an issuer having superior voting rights compared to all other equity shares issued by that issuer).
[13] Regulation 31(B) of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

should be aimed at striking a balance between investor interests and regulatory objectives and fostering an environment that safeguards investor confidence while upholding the integrity of the IPO process. It will still have to be seen how SEBI treats such clauses.

5. CONCLUSION

The recent initiatives taken by SEBI to restrict Selling Shareholders from influencing the pricing of IPO signify a pivotal shift in market dynamics. SEBI's focus on enhancing transparency and mitigating potential conflicts of interest is evident in its scrutiny of offer documents and the push to limit the role of Selling Shareholders, particularly PE and VC investors.

As SEBI works towards ensuring a more equitable and transparent IPO pricing process, the implications for Selling Shareholders, especially those with substantial influence, necessitate a reassessment of existing practices, especially under the SHA. Observations made by SEBI will serve as the *de facto* law, establishing new boundaries for private and public investor rights in coming times. Within the framework of the SHA, considerable amount of time is spent on negotiating the terms governing exits, particularly in the context of IPOs. There is a prevailing expectation that Selling Shareholders will exert significant influence over the decision-making process pertaining to IPO. However, as a way forward, Selling Shareholders may agree to not interfere in the IPO process, provided that the IPO meets certain predefined criteria agreed upon at the outset of their investment in the company. This contrasts with the traditional 'governance led' approach and brings a subtle shift for how Selling Shareholders will navigate their roles and responsibilities within the cap table.

While the restrictions may pose challenges for Selling Shareholders seeking to maximize gains, it seems to be the view of SEBI that such restrictions will contribute to the overall health and credibility of India's capital markets. As market participants adapt to this evolving regulatory landscape, the emphasis on fair pricing and investor interests both should be kept in mind. While broader interest of the company and post IPO investors is of utmost importance, it should not come at a cost of the interests of existing investors who have been backing the company before going public.

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