Why Non-Pari Passu Concept Should Not be Revived?

Once again, the market circles are buzzing with the news that some of the listed companies and banks have been busy in campaigning and pressing their demand for reviving the concept of issue of non-pari passu shares. This article probes the concept.

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Apparently, the suggestions to revive the concept of issue of non-pari passu shares include some new versions and hover around the fact that the listed companies including banks are required to pay full dividend due to the reason that all the shares are required to rank pari passu in all respects, whereas unlisted companies enjoy the freedom to pay dividend in proportion to the paid-up share capital on the lines of model regulation 88(3) of Table A to the Schedule I of the Companies Act, 1956. Further, in case of the shares allotted on preferential basis, the new shares so allotted are subject to a lock-in for a minimum period of one year from the date of allotment pursuant to the guidelines issued by SEBI and that there would be an unfair advantage if such shareholders receive full dividend when such shares were allotted during the course of the financial year despite the fact that the shares allotted to them can be identified even if they happened to be in electronic form.

Position prior to 8th February 2000

In this context, it will be pertinent to critically review the demand for revival of the proposal purely from the perspective of the investor and before doing so let us analyse the background of the market practices which were in tune with the then prevailing regulatory guidelines. Shares issued in physical form and which continued to be held in physical form were easily capable of being identified by their respective distinctive numbers as provided in Section 82 of the Companies Act, 1956. Thus in respect of shares held in physical form, it hardly mattered as to whether the shares were issued during the earlier financial year/s or after the commencement of the new financial year, for the purpose of classification into pari passu and non-pari passu, which was a prerequisite for determination of eligibility or the quantum of dividend. Thus, these shares did not suffer from any identity crisis and hence presented no difficulties for the purpose of distinguishing due to their inherent characteristic.

Birth of NPP ISIN

However, after introduction of the facility of dematerialised holding of securities in the year 1996 and the problem of identity and distinction between different categories of shares issued by a company at various points of time assumed overwhelming importance since the shares held in dematerialised form were fungible and they did not bear any distinctive numbers. This matter became more critical and was further accentuated after the Securities and Exchange Board of India (SEBI) literally pushed and thrust the new facility and ordered that trading and settlement in dematerialised form was compulsory starting from a few scrips during the year 1998 and extended to all listed securities in early 2000. Accordingly, to keep pace with the changed environment, the non pari passu (NPP) concept which was applicable to the shares held in physical form was extended to the shares held in demat form and this heralded the birth of a new category of International Security Identity Number (ISIN) called non pari passu (NPP) ISIN, in tune with the regulatory guidelines. Under this arrangement, the shares issued during the course of financial year in dematerialised form were classified and allotted under a different (ISIN) and they were entitled to a proportionate dividend from the date of allotment of shares. This rendered the task of distinction of old shares (Pari Passu) from the new shares (NPP) very simple and it catered to the limited object of the facilitation of computation of proportionate dividend for the new shares.

By its very design, the NPP ISIN was a temporary phenomenon and it was having a limited life i.e. up to the date of the next book closure or the record date. Thus after the commencement of the earliest date of closure of the register of members or the record date, as the case may be, for the purpose of determination of en-

titlement of dividend, upon application by the company or its RTA the entire balance of shares in NPP ISIN was transferred to the PP ISIN through the auto corporate action route and simultaneously the NPP ISIN was deactivated permanently. In actual practice, some of the companies issued shares in different tranches during the same financial year, and hence in some cases more than one NPP ISIN in the same company came to be allotted. At the same time, investors who had obtained allotment of shares in physical form had no means to know about different ISINs with reference to their details and when they tendered the shares under the old ISIN for dematerialisation, saw their damat requests rejected for obvious reasons. Moreover, the sheer multiplicity of ISINs in the same company created confusion in the minds of investors.

Dividend Adjustment

For an investor who purchased or sold the shares of any company through the trading platform of a stock exchange, no distinction was made between the two categories of Pari Passu or Non Pari Passu shares, since entering and execution of any trade was in the shares of the company with no reference to any particular ISIN. The most fundamental factor to be considered was the transaction always pertained to pari passu shares and hence the effective performance of the contract called for delivery of pari passu shares in respect of every trade. The investor obviously is entitled to all the rights and obligations associated with the attendant benefits and there was no scope for compromise on this aspect.

However, when the investor who had sold the shares delivered the shares belonging to the NPP category, while full consideration was paid to the selling broker at the contracted price in the settlement mechanism, the applicable dividend (amount of dividend declared for the previous financial year) was required to be deducted from the sale proceeds through the selling broker and was passed on to the investor who had purchased the said shares through the buying broker. This procedure ensured that the buying investor, with whom the NPP shares had eventually landed, was paid proportionate dividend in respect of such shares.

Market Complications

Up to this point, every thing seems to be fine. The story however is not really so simple, as it would sound to be. In order to gauge the efficacy of the prevailing methodology, the practice has to be evaluated as to what it translated to the investors. The trouble started when the shares categorised under the NPP ISIN were delivered in the settlement mechanism of the stock exchange/s to discharge the pay in obligations of the transactions, and if by that date, the NPP shares were converted in PP ISIN, the deliveries failed since there was no balance in the NPP ISIN. In a completely system driven environment of trading and settlement, such deliveries were unfortunately treated as shortages and were auctioned, since shares delivered are ISIN specific. This hurt the investor in both the ways. He was not only required to bear the burden of auction difference but was also deprived of the sale proceeds, not to speak of the opportunity loss, even though he had the relevant shares in his possession and had given instructions to transfer the said shares towards pay in obligations. The investor was punished for no fault of his and suffered heavily in the process.

Discontinuation of Non-Pari Passu Concept

This created a hue and cry in the market circles and some basic questions were raised about the reconsideration of certain practices. Several financial institutions including mutual funds during the course informal discussions supported the move and more importantly some of the investor associations representing individual investors during investor awareness programmes pointed out the inconvenience caused to them on account of non pari passu shares. Taking a clue from these complaints and the feedback received from the institutional investors, SEBI initiated a dialogue with the market participants and examined the pros and cons of the non pari passu shares. After further deliberations with the representatives of the market constituents at the Secondary Market Advisory Committee and having regard to the protection of investors, SEBI decided that the shares issued by any issuer (which comprises of the companies, banks and all other entities which issue shares) would be pari passu in all respects so that the same ISIN could be allotted. With this decision, SEBI abolished the concept of non pari passu (NPP) ISIN from 8th February 2000.

As a result, additional shares allotted during the course of the financial year were required to be categorised under the classification of "existing ISIN" and in effect, all the shares of the company irrespective of the date of allotment became to be treated as pari passu (PP) along with the existing shares of the company.

Relief to Investors

This development brought enormous relief to the investors, who otherwise were made victims of circumstantial changes brought about in capital market infrastructure as a sequel to the reforms stemming out of economic liberalisation and financial sector reforms ostensibly meant for his benefit (although ironical). During the course of over five years after discontinuation of the non pari passu concept, market practices have fully stabilised in the right direction and all the investors and market constituents have become crystal clear about the features and the implications in terms of rights and obligations in performance of contracts in listed shares. This has enhanced the levels of comfort and convenience from the point of view of the understanding of the concept and its smooth implementation by the market constituents has been amply demonstrated.

No Need to Revive NPP

Since the circumstances that prevailed prior to 8th February, 2000 continue to haunt the memories of the investing community even today and further that they are not likely to undergo any material change in the foreseeable future, the concept of pari passu should be retained and continued in the present form. On the other hand, in case the non pari passu concept is revived, it will lead to disastrous consequences in terms of market complications and resultant loss to be suffered by the investors, in the absence of alternate remedies and options to compensate them in monetary terms.

Dividend – a Market Related Function

Now let us look at the allegation that entitlement of full dividend in respect of new shares puts the existing investors at a disadvantage. The argument lacks any justification or rationale evaluated from any angle. There are three strong reasons for this. First of all, an equity share is not a tenure-based instrument, unlike the debt. Dividend, which could be distributed either out of current profits or out of accumulated profits and reserves, is not a tenure driven benefit. Secondly, infusion of fresh capital in a company would enhance its earning capacity and naturally existing shareholders would be entitled to their share in the prosperity flowing thereon. Thirdly, in a competitive market, the transaction price is determined by the constant interplay of the forces of demand and supply and the market price being the ultimate barometer discounts all relevant factors. In essence, market price of any share whether subscribed from the company directly or acquired from the secondary market has a component of dividend (or absence of it) embedded in it along with other determinants like past earnings, future potential, quality of management, level of corporate governance and philosophy about rewarding of the stakeholders. Thus in a free pricing scenario, dividend undoubtedly is a market determined function. It is therefore evident that an investor who has purchased the shares from the trading platform of a stock exchange i.e. from secondary market or subscribed to the IPO/or by way of rights has already paid its full price, including the dividend component.

Preferential Allotments

The same argument is equally true to the preferential issues also. In respect of shares issued on preferential basis, the shares are issued at a premium in accordance with SEBI guidelines for preferential allotment and such investors have thus contributed in abundance for the benefits derived from such allotments. It is well known that quantum of dividend, which is computed on the paid up value per share, is a pittance when compared to the consideration paid by such allotters. Existing shareholders should not forget that they are the ones who have permitted such preferential allotments by passing the necessary resolutions and they are well aware that the company stands to benefit from the premium paid by the preferential allotters. Therefore the argument that payment of full dividend to the allotters for the shares held for a part of the financial year places the existing investors at a disadvantage is entirely misconceived and misconstrued. It is also misleading and mischievous for the reasons explained above and therefore could not be a ground for revival of the non pari passu concept.

Date of Allotment is Not the Lone Criterion

Incidentally it is interesting to note that regulation 88(3) of Table A is not rigid about payment of dividend which is proportionate to the amount paid up on the shares. It in fact contains an enabling provision to the effect that if any share is issued on terms providing that it shall rank for dividend as from particular date such shares shall rank for divided accordingly. What could be done is that the fact that the new shares would be entitled to full dividend could be disclosed in the offer documents or in resolutions to be passed by the shareholders while authorising such fresh issue of capital. ❐