



# REGULATORY HURDLES IN LISTING OF SHARES OF NON-PROFIT COMPANIES

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## ABSTRACT

Companies Act, 2013 provides for incorporation of non-profit companies (NPCs) under section 8 of the said Act.

The Working Committee appointed by Securities and Exchange Board of India (SEBI) for making recommendations on social stock exchanges has in its report submitted to SEBI observed that there are no regulatory hurdles for the NPCs in listing their equity shares on recognised stock exchanges.

This paper names and discusses the legal and regulatory hurdles in the non-profit companies in listing their shares on a recognised stock exchange in the context of the existing provisions under Companies Act, 2013 (CA), Securities Contracts (Regulation) Act, 1956 (SCRA), Securities Contracts (Regulation) Rules, 1957 (SCRR), and relevant SEBI Regulations. The papers also attempt to identify the market constraints that may come in the way of creation of liquidity in the shares of such companies.

This paper argues that further study is needed to assess whether the listing of shares of the NPCs on recognised stock exchanges in achieving their objectives. If the study results in identifying the positives in allowing such listing of shares, this paper suggests the changes to be made to the CA, SCRA, SCRR and relevant SEBI Regulations to facilitate the same.

**Keywords:** non-profit social enterprises (NPCs), Securities and Exchange Board of India (SEBI), listing. CA, SCRA, SCRR.

## 1. INTRODUCTION

### 1. Background

Companies need capital for growth and its operations. Capital requirement is essential for companies to achieve their objects and goals. Companies may raise capital in the



form of equity or debt. Capital in the form of equity is a helpful form as the shareholders share risk and rewards based on their shareholding in a company.

Primary issuance in securities market is a better avenue for companies to raise equity capital as they can approach substantial number of public shareholders and raise sufficient capital needed for the company. However, in such case the companies shall list their equity shares on a recognised stock exchange. Stock exchanges provide a trading platform to the investors to trade in the securities held by them. The listing of shares on a stock exchange creates liquidity to shares of a company and facilitates the exit as and when required by the shareholders of a company. Thus, the liquidity is provided to the investors who hold shares in the company.

The transparent disclosure mechanism provided by the stock exchange in relation to the periodic financial information, operational performance and any material events that will affect the performance of a company would create a level playing field for the public shareholders and creates a credibility of securities market in the perception of the public shares holder and facilitate the companies to raise capital in the form of equity.

Non-profit companies (NPCs) incorporated under section 8 of the Companies Act, 2013 can issue equity shares. However, the shares do not stand for a residual claim on the profits of the NPC, as NPC is prevented under the Companies Act, 2013 to distribute dividends to the shareholders.

SEBI appointed working group on 'Social Stock Exchanges' (SSE) under the Chairmanship of Shri Ishaat Hussain on September 19, 2019 (Working Committee). made several observations on the requirements for SSEs and social enterprises proposed to be registered or listed on the SSEs and submitted its report. The Working Committee identified the legal issues and tax-related issues that are required to be addressed by the government and SEBI for the effective achievement of the objectives in setting up the SSEs and facilitating the social enterprises to raise capital using the SSEs as a platform. In its report, the Workings Committee observed that no regulatory hurdles in listing shares or debt instruments of NPCs and felt that avenues are there for direct listing by select NPOs. It has further observed that the inability of NPCs inability to provide



financial return on investments could be a reason as to why the NPCs have not availed the avenue of listing.

This paper examines and attempts to address the questions such as does the NPCs face any legal and regulatory constraints in listing their equity shares? Are there any market constraints in advancing the cause of listing equity shares of NPCs on stock exchanges?

This paper studies the existing legal provisions to understand the constraints in listing the equity shares of NPCs. This paper also attempts to name the market constraints in creating a liquidity in the listed equity shares of NPC.

This paper analyses the relevant provisions of the Companies Act, 2013, Securities Contracts (Regulation) Act, 1956 and the rules made thereunder, Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations 2018, Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015 and Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 2011 to identify the legal and regulatory issues involved in the listing of equity shares of NPC.

## **2. ANALYSIS OF RELEVANT PROVISIONS OF COMPANIES ACT, 2013**

The definition of 'securities' under the Companies Act, 2013 (CA) refers to the definition of securities under Securities Contracts (Regulation) Act, 1956. The said definition is elaborately discussed hereinafter.

Section 8 of CA provides for establishment of NPCs and facilitate any person or an association of persons to register as NPC if the objects of such entity, inter-alia, include promotion of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment or any such other objects coupled with an intent to use its profits or income for any of the aforesaid said objects and restricts the distribution of profits to the members. Notably, the word social welfare is so wide to include providing any health care facilities to the needy members of society. It meets the objective of section 8 company.



NPC will have all the privileges and obligations as applicable to the limited companies and can be a private limited company or a public company or omit such words from its name.

The CA empowered the Central Government to revoke the license granted to an NPC if it is found that such NPC has acted in contravention of the applicable provisions or any conditions subject to which it was registered or if the affairs of it are conducted in a fraudulent manner. In such an event, the Central Government may direct the NPC to convert into a limited or private limited company, and the registrar on application shall register the NPC accordingly after giving an opportunity of hearing to NPC. The Central Government may, in the public interest, on revocation of license direct the NPC to be wound up or amalgamated with another NPC registered with similar objects.

The Central Government has granted exemption from several provisions of CA, which, inter-alia, include:

- i. NPC can appoint a person as a company secretary who does not qualify or fall within the definition of company secretary as defined under Section 2(1)(c) of the Company Secretaries Act, 1980.
- ii. NPC can fix the date of the next annual general meeting in the meeting of shareholders and based on the instructions of the shareholders, and the board can call for the AGM. In case of companies other than NPC, the board of directors alone have power to fix the time, date and place of each annual general meeting.
- iii. NPC general meetings may be called by giving not less than clear 14 days' notice as unlike a clear 21 days' notice needed in the case of for-profit companies.
- iv. Section 118 of CA which deals with minutes of proceedings of General Meeting, Meeting of Board of Directors and other meeting and resolutions passed by postal ballot will not apply to NPC except that minutes may be recorded within 30 days of the conclusion of every meeting in case of NPCs where the articles of



association provide for confirmation of minutes by circulation.

- v. NPC may send the financial statements not less than 14 days before the meeting while other for-profit companies shall circulate the financial statements not less than 21 days before the annual general meeting.
- vi. Unlike other for-profit companies, NPC has no restriction of minimum and maximum number of directors on the board of the company and there is no requirement for appointment of independent directors.
- vii. Section 160 of CA related to the right of persons other than retiring directors to stand for directorship is not applicable to NPC whose articles provide election of directors by ballot.
- viii. NPC is not subjected to the restrictions under section 165(1) of CA with respect to the limit on the number of directorships as in the case of for-profit companies.
- ix. Unlike other for-profit companies which shall hold 4 board meetings every year with a gap of not more than 120 days, NPC is allowed to hold only 1 meeting within every sixth calendar months.
- x. Unlike other for-profit companies, for NPCs the quorum for board meetings shall be lower of: (a) 8 members; or (b) twenty-five percent of its total strength.
- xi. NPCs can constitute an Audit Committee without independent directors.
- xii. NPCs are exempted from the requirement of constitution of Nomination and Remuneration Committee and Stakeholders Relationship Committee.
- xiii. NPCs are exempted from requirement to exercise of powers by the Board at the Board Meeting and instead transact through circular resolutions



- xiv. NPCs' directors are exempted from the requirement of making disclosures in any related party contract or arrangement if the value of such contract or arrangement does not exceed INR1,00,00/-.

The above exemptions provide a flexibility to NPCs by giving a lenient procedural requirement to the NPCs considering that the NPCs run on non-profit basis unlike the public limited companies who are for profit companies. NPCs may have to follow rigid norms prescribed by applicable SEBI regulations if listing of their equity shares and may have to forego some of the exemptions granted under CA form compliance considering the non-profit nature of the NPCs. That would increase the cost of compliance for the listed NPCs and diversion of funds raised for achieving the social objectives will be diverted for spending on compliance cost.

### 3. ANALYSIS OF RELEVANT PROVISIONS OF SECURITIES CONTRACTS (REGULATION) ACT,1956

Securities Contracts (Regulation) Act,1956 (SCRA) regulates the conduct of the securities market. Section 2(h)(i) of SCRA defines securities extensively and includes shares, debentures, bonds, or other marketable securities of like nature in or of any incorporated company, a pooled investment vehicle, or other body corporate. The judicial interpretation as laid down by the Bombay High Court in the matter of “*Dahiben Umedbhai Patel & Others v/s. Norman James Hamilton & Others*” is that the shares or other securities of the incorporated companies should be marketable to fall within the definition of ‘securities’ and therefore the shares of a private company are not securities under SCRA. However, in the context of a decision involving the unlisted public limited company, in the matter of “*A.K. Menon v. Fairgrowth Financial Services Ltd.*” A special court constituted under the a Special Court (Trial of Offences Relating to Transactions in Securities) Act, held that the word marketable should be construed as capable of being getting listed and sold on the stock exchange, and therefore, the shares of unlisted public company, even if they are not listed being freely transferrable and capable of getting listed on stock exchange should be construed as securities under SCRA. The rationale for the above proposition by the said court was that the definition of securities under SCRA is wide and “*all securities which are marketable and which*



*have an ease or facility of selling and/or which have a high degree of liquidity and/or are capable of being sold in a market, i.e., stock exchange, are included”*

Section 21 of SCRA provides for listing of shares, debentures, or bonds issued by a public company with no selling restrictions can be listed on recognized stock exchanges. Any company that intends to list should enter into a listing agreement with the stock exchange. Section 13 of SCRA stipulates that the transactions in the securities must be traded only through the members of a recognised stock exchange or on a recognised stock exchange. Section 18 provides an exemption from the provisions of SCR for a transaction made outside the stock exchanges if it is spot transaction. That is the delivery and payment are made within the stipulated period under SCRA or for a transaction done by way of transfer through a depository. The implication of the foregoing is that the shares of even unlisted public company to be legally valid must be conducted as a spot transaction.

In the context of the same, it is necessary to examine the provisions of Securities Contracts (Regulation) Rules, 1957 (SCRR) that deal with the listing of shares. Rule 19(1) of SCRR provides that, if a public company as defined CA desires to get its securities listed on a recognised stock exchange shall make an application to the stock exchange for that purpose. Rule 19(2) of the SCRR, inter-alia, prescribe that every such public company shall offer and allot at least 25% to 10% shareholding to the public based upon the post issued capital of the public company as an eligibility criteria for listing, Rule 19A provides as a continuous listing requirement at least 25% public shareholding for every listed public company (other than public sector company), and the timelines within which it should be achieved, if the public shareholding falls below that.

It is clear from the above, under SCRA read with the SCRR, any NPC registered as a public limited company may be technically able to list its shares on a recognised stock exchange.

#### **4. ANALYSIS OF RELEVANT PROVISIONS OF SECURITIES AND EXCHANGE BOARD OF INDIA REGULATIONS**



In this context, it is also relevant to examine the relevant regulations made by Securities and Exchange Board of India (SEBI) which is a regulator of the securities market and in the process regulate the public issues and the listed companies.

(a) SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018

SEBI (issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR) spells out the eligibility, requirement for issue of capital and the process to be followed by the entities that propose to list their securities on recognised stock exchanges.

Regulation 6 (1) of ICDR stipulates the eligibility criteria for an issuer, inter-alia, as:

- (i) net tangible assets of at least three crore rupees, calculated on a restated and consolidated basis, in each of the preceding three full years (of twelve months each), of which not more than fifty per cent. are held in monetary assets;
- (ii) an average operating profit of at least fifteen crore rupees, calculated on a restated and consolidated basis, during the preceding three years (of twelve months each), with operating profit in each of these preceding three years;
- (iii) net worth of at least one crore rupees in each of the preceding three full years (of twelve months each), calculated on a restated and consolidated basis.

However, it is very much doubtful as to whether an NPC which runs on a non-profit basis would be able to meet the above eligible criteria. The above conditions could be a constraint for an NPC to make public offer.

Regulation 6(2) of ICDR provides that if an issuer is not able to satisfy the above conditions and other conditions set out in Regulation 6(2) of ICDR, still it will be eligible to make initial public offer provided the issue is made through the book-building process and the issuer undertakes to allot at least 75% of the net offer to qualified institutional buyers and to refund the full subscription money if it fails to do so. This relaxation is provided as the subscription of 75% of the net offering by the qualified institutions, who are sophisticated investors give a comfort that though the issuer is not eligible, there are sufficient grounds for the growth of the issuer. But it would be difficult for NPC to meet the above condition of allotment of 75% of the net offer to the qualified institutional investors. Based on the profit intent nature, the





qualified institutional investors may not be willing to subscribe to such extent more particularly since no distribution of profit by NPCs is permissible under CA.

Regulation 292A (c) of ICDR includes in the definition of Non-Profit Organisation (NPO) the NPC incorporated under section 8 of the CA. However, all NPCs will not fall under the said definition as the objects of NPC covered under the definition should include the primacy of social intent and conduct at least one of the social objects included under Regulation 292E (2)(a) of ICDR. Interestingly such activities listed in the said Regulation, inter-alia, includes promoting health care including mental healthcare, sanitation and making available safe drinking water, promoting education, employability and livelihoods etc, Notably, while the CA allows objects such as political or religious activities as objects of NPCs, those activities are not permissible for an entity to be identified as NPO under ICDR.

Regulation 292G facilitates the NPOs to raise the funds by issuance of zero coupon and zero principal bonds. It also provides that a for-profit organisation can raise funds through issue of equity shares on the main board, SME platform or innovators growth platform. However, it is silent on the issue of equity shares by any NPC falling under the definition of NPO.

(b) SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2018

SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2018 (LODR) provides for various requirements and obligations to issuers post listing. Such obligations include the requirement of independent directors on the board, constitution of the audit committee and nomination and remuneration committee, circulation of financial statements to shareholders, disclosure of quarterly results approved by the board, approval of related party transactions by the audit committee etc. Therefore, though NPCs may be exempted from complying with such requirements, as a listed company, they would be required to comply with such requirements under LODR, which as mentioned before increase the cost of compliance and diversion of funds raised for meeting the social objective for meeting the compliance costs. These requirements under LODR conflicts with the objective of exemption granted to NOCs section 8 of the CA

(c) SEBI (Substantial Acquisition Takeovers) Regulations, 2011



SEBI (Substantial Acquisition Takeovers) Regulations, 2011 (SAST Regs) provide for a mandatory public offer if any acquirer together with persons acting in concert acquires shares entitle them to exercise twenty-five percent or more of the voting rights in such target company, then the mandatory open offer requirement to acquire at least 26% shareholding from the public shareholders triggers. Similarly, if there is a change in control irrespective of shareholding, then such an event triggers mandatory open offer.

The objective of the SAST is to ensure equal treatment to all the shareholders. Therefore, when a shareholder in control sells his stake, he might get a control premium. The intent of the SAST is to provide exit to the other shareholders and sharing of control premium. One of the reasons for the acquirer of control to make a mandatory public offer is that the acquisition of control provides extraction of private benefits such as driving the business of the target company. The remaining shareholders might have subscribed to the acquired shares of the target company based on their understanding of the existing promoters or controlling shareholders. If a new shareholder is acquiring control, the remaining shareholders should also be provided exit along with the outgoing promoters or controlling shareholders.

The acquirer who made a mandatory public offer is required to make offer at a higher price prescribed under the SAST, which, in the case of frequently traded shares of the target company is based on the trading price of the shares for the periods stipulated or acquisition price paid by the acquirer to the controlling shareholders. However, in the absence of frequent trading, it is based on the fair value. Both these conditions may not be appropriately applicable in the case of NPCs, where the shareholders are entitled only to residue in the winding up and not entitled to any distribution of profits.

However, it is not clear as to how the above provisions of SAST, which are meant for-profit companies work in the case of substantial acquisition of shares or takeover of a NPC, more particularly since there is no possibility of distribution of profits to the shareholders under law. SEBI should take steps to remove this ambiguity if it proposes to allow the listing of shares of NPC on a recognised stock exchange by making proper amendments to SAST.



## 5. Liquidity Risk

Even if SEBI addresses all the legal constraints in listing of the shares of NPCs, still there could be a problem of lack of liquidity for the NPCs' shares considering that the NPCs and non-profit companies are prevented from making distribution of dividends and may not have any residue value.

Generally, the NPCs being a non-profit organisation may obtain tax exemption for the subscriptions made towards its capital. However, as mentioned above, since the shares have no residue value, there may not be any interest for the investor to acquire in the secondary market. Further, there will be no tax relief for a buyer who makes secondary purchase of the shares of NPC as he will not get any capital gain or capital loss treatment except in the case of winding up where there is a residue.

## 6. Conclusions And Suggestions

As discussed, and analysed above, there are many legal and regulatory constraints under SCRA, SCRR, and SEBI Regulations such as ICDR and LODR on the initial public offer of shares of NPCs. For the reasons elucidated above, the observations of the working group appointed by SEBI that there are no regulatory constraints in listing of shares of NPCs appears to be misplaced.

Further study is needed to examine whether the objective of achieving the social goals will advance by facilitating the listing of equity shares of the NPCs. If the further study finds utility in the listing of the shares of NPCs on a recognised stock exchange, the central government and SEBI shall take joint steps for amending the CA and applicable securities laws provisions simultaneously to remove the legal constraints. Some of such amendments may be like, SEBI may have to grant exemptions to NPCs from compliance with the eligibility criteria stipulated for the issuer under Regulation 6(1) of ICDR and make a proviso exempting the NPCs from such requirements subject to the proper conditions as may be applicable. Alternatively, SEBI may amend the provisions of ICDR relating to social stock exchanges to facilitate the listing of shares of NPCs. SEBI may amend the ICDR providing for listing of NPCs on Social stock exchanges with lower listing fee and simple documentation without involvement of



merchant bankers to reduce the cost burden as a part of the subscription money will be unnecessary incurred for issuer expenses instead of spending on the social goals.

SEBI may relax some of the requirements under LODR and impose lenient conditions in comparison with the other listed for-profit companies considering that the investment in the NPCs will be virtually as a grant without any profit motive. Similarly, SEBI may remove the ambiguity with regard to the applicability of SAST to the NPCs and may impose some sort of measure to regulate the takeovers of NPCs in a manner that suits such entities to meet the social objectives and to ensure that the objective of the shareholders in investing in such NPCs is achieved.

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