Warrants: Investment tool or an instrument of abuse?

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Warrants are market driven, investor friendly, low risk financial instruments, which give the holder the right but not the obligation to buy a certain quantity of an underlying security at a certain price and future time until the expiry date. A warrant is exercised when the holder informs the issuer of its intention to purchase the security underlying the warrant. The security, usually equity shares, is delivered by the issuing company.

Warrants were devised to generate an immediate flow of funds into the issuing company. In exchange for an upfront cost, also known as the warrant premium, the buyer of a call warrant can profit from large upward movements in stock prices while limiting the downside.

Warrants typically offer high transparency and low cost. They also permit private investors to command a large amount of equity with a relatively small initial investment.

Regulatory framework

Under section 81(1A) of India's Companies Act, 1956, shares may be issued to a select group of persons on a private placement basis. The Securities and Exchange Board of India's SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (ICDR Regulations), govern financial instruments, including warrants which can later be converted into shares by listed companies, issued to any select group of persons under section 81(1A) of the Companies Act. The ICDR Regulations replaced the SEBI (Disclosure and Investor Protection) Guidelines, 2000 (DIP Guidelines).

Recent complaints

Norms for preferential allotment of equity warrants came under the regulatory scanner in India recently, following complaints from institutional investors of misuse by promoters. Equity warrants are mostly issued by promoters to themselves, to increase their stake in the company in a cost-effective manner.

Under the ICDR Regulations, warrants become due for conversion into shares at the end of 18 months from their date of allotment. SEBI has increased the upfront margin which is to be paid at the time of issuing the warrants to 25% from 10% under the DIP Guidelines.

When the stock market was booming, many promoters issued warrants to themselves in the hope that they would be able to convert them into shares at a significant discount to the market price prevailing at that time. But the stock market crash that began in 2008 upset the calculations of the warrant holding promoters.

As a result, many promoters allowed warrants to lapse as the conversion price was way above the market price when it was time to exercise their option.

An unprecedented trend was triggered when some companies where the promoter warrants had lapsed started issuing fresh warrants to the promoters at lower prices. This destabilized the confidence of minority shareholders in the company.

Recourse unclear

Warrants do not carry any voting, shareholding or dividend rights. Investors who only hold warrants have no say in the functioning of the company, even though they are affected by any decisions made, and they may face challenges in enforcing their rights if the issuing company refuses to convert the warrants. It is unclear whether jurisdiction in such matters would lie with SEBI, as the market regulator, or with the Company Law Board, where all matters relating to shareholding disputes are filed. In the past the Company Law Board has issued some decisions in matters relating to the enforcement of rights of warrant holders.

Steps to curb abuse

SEBI has, from time to time, taken steps to curb the use of warrants as abusive devices. To tighten the preferential allotment framework, SEBI in 2010 decided that any promoter who has previously subscribed to warrants of the company but failed to exercise the warrants would be ineligible for a preferential issue of warrants for a period of one year from the date of expiry or cancellation of the previous warrants. Further, any promoter who has sold shares in the previous six months would be ineligible for allotment on preferential basis.

SEBI has also amended the Listing Agreement to lengthen the lock-in period for promoters holding warrants, and has made it mandatory for listed companies to disclose details regarding the use of funds raised through warrants, to ensure that warrants are issued and used for proper reasons. Such amendments have been introduced to elevate the credibility of warrants as financial instruments and bring more transparency to capital markets.

SEBI has wide powers to issue orders and directions to protect the interest of investors. In the past, SEBI has even directed specific promoters to convert their warrants when they had committed to do so.

Thus, although warrants are potentially attractive revenue generating instruments both for the issuing company and for holders of warrants, in India constant vigilance by the market regulator has been required to ensure the just and fair use of the instrument.

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