

Telecom Hotline

July 30, 2009

INDIAN GOVERNMENT MANDATES EQUITY LOCK-IN FOR TELECOM COMPANY

On July 23, 2009, the much speculated and awaited regulation for equity **lock – in**, in the telecom sector became a reality. The Department of Telecommunications (“DoT”), vide Circular No. 20-100/2007-AS-I, (“**Circular**”) imposed a three year lock in restriction for the sale of shares by certain shareholders in telecom companies. DoT had earlier sought the recommendations of the Telecom Regulatory Authority of India (“**TRAI**”) and TRAI had provided its recommendations after a process of consultation and deliberation. The Circular has been directed towards companies holding the Unified Access Services (“**UAS**”) license who are allowed to provide wireline as well as wireless services in a service area.

BACKGROUND

Lock-in restriction for the promoters of telecom licenses is not a new phenomenon. Such restrictions existed (both for foreign and Indian promoters) when the Cellular Mobile Telephone Services (“**CMTS**”) licenses were initially granted in 1995. Subsequently, there was a migration from the fixed license fee model to a revenue share model along with a five years lock-in period. Thereafter, the UAS license was amended in 2005, whereby the lock-in restrictions were removed.

Telecom operations are essentially dependent on spectrum which is not freely available and is a scarce resource. Currently, spectrum is allotted as a bundled right along with the telecom license. Faced with spectrum shortage, in 2007 the DoT had considered putting a cap on the number of operators¹. This was followed by a huge rush for telecom licenses which raised concerns that non-serious players were likely to obtain the license (and spectrum) and then sell it at a premium. It is likely that the government introduced this Circular with an aimed to prevent non-serious /fly-by-night operators from making profits/ windfall gains.

SALIENT FEATURES OF THE CIRCULAR

- The restriction is imposed on persons whose share capital in the company is 10% (such persons shall individually and/or collectively be referred to as “**Shareholder(s)**”) or more and whose net worth has been taken into consideration while determining the eligibility of the company for the UAS license.
- The restriction is effective from the date of grant of the UAS license and is valid till the earlier of (i) three years from such grant or (ii) the completion of all roll out obligations of the licensee².
- Issue of additional equity by the UAS licensee company by way of private placement/ public issue is permitted.
- During the lock-in period, the Shareholder shall not in any manner, (such as sale, assignment) transfer his share capital directly or indirectly to any other person.
- Dividend declaration or special dividend would not be allowed against the issue of fresh equity during the lock-in period.
- Such lock-in restrictions shall not apply where the UAS licensee company has committed breach and lending/ financial institutions/ banks seek enforcement of pledge.

ANALYSIS

The intention of DoT in allocating spectrum along with the UAS license is to ensure that the same is utilized by the licensee company to provide telecom services. It has been increasingly witnessed that certain non-serious companies obtain the UAS license with the sole object of directly or indirectly making profits; thereby defeating the purpose of the license being granted. Such practices result in the “trade” of spectrum which is a scarce national resource. Further, the applicability of the restriction till the completion of the roll out obligations of the UAS licensee company seems to tie in with the very reason why a telecom license is granted to a company.

The restriction on the declaration of dividend can be co-related to the provisions of the Indian Companies Act, 1956 (“**Act**”) which provides that dividends can only be declared from the distributable profits of the company³. As such, it may not be possible for a new telecom entrant to declare dividends during the lock in period as it is unlikely that the business of such company would be profitable in its initial stages. However, in furtherance of the provisions of the Act, it is to be evaluated whether such a restriction would be applicable in cases where interest is paid on the shares issued by the company for defraying the costs of works or building or of plant which cannot be made profitable over a long period⁴.

TRAI has noted in its consultation process, that some operators have contended that the extremely high net worth requirements for promoters as set out in the UAS license coupled with the merger guidelines relating to intra-service

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area merger of CTMS/UAS⁵ by their very nature demand that dedicated and committed players enter this sector. Further there have been arguments that such restrictions would make investment in the telecom sector unattractive. This Circular however does not impose any restrictions on inbound investments in the UAS licensee companies and would not prove as a deterrent for future investment by committed players. The Circular itself permits issue of additional equity within the lock-in period. Further, in such cases of issue of additional equity, the Shareholders merely need to ensure that they do not transfer their shares to any third person. There is no requirement that the Shareholders would need to increase their shareholding by acquiring further shares whenever the company issues additional equity so as to maintain their respective shareholding percentage in the company. Further the Circular does not restrict the transfer of effective control of the licensee company itself, inspite the Shareholder not being able to transfer their shares to any third person⁶.

CONCLUSION

Through this Circular, the government seeks to achieve its objective of encouraging committed players to invest in the telecom sector. However this Circular has left some important issues unanswered and is likely to attract criticism from some fronts on the restrictive nature of the lock-in provisions. For those genuine investors who may need an exit during the lock-in period, a prior approval of DOT would be required. These restrictions could also bring up issues where the completion of lock-in period/ roll-out obligations is made a condition precedent to the transfer of shares in companies having a UAS license.

Further, the Circular does not deal with a situation where a Shareholder in an existing licensee company has prior to the Circular, already sold its shareholding or part thereof before the completion of 3 years from the effective date of the license or meeting the roll out obligation. The question which therefore arises is how will such Shareholders be treated and will the lock-in apply with respect to their remaining shareholding?

Also, situations where existing telecom players after successfully rolling - out services in certain circles are seeking licenses in additional circles as expansion plans and whether such lock-in restriction would apply to such players.

Though it is the government's imperative to alter the terms of the UAS license at any time⁷, clarity on applicability of the current amendments is required. It is likely that the industry would compel the government to issue a clarification stating that the Circular is to have prospective application.

Telecom Practice Team

Sources:

TRAI Recommendations on Lock-In Period for Promoter's Equity and Other related for UASL:http://www.trai.gov.in/Recommendations_content.asp

<http://www.dot.gov.in/>

1 (i) Refer DoT's letter dated 13th April 2007 seeking TRAI's recommendations dated April 13, 2007, (ii) <http://www.thehindubusinessline.com/ew/2007/10/15/stories/2007101550030100.htm>

2 Under Article 34 of the UAS license, the licensee needs to comply with a milestone based roll out structure which is to be completed within three years from the effective date of the license.

3 Section 205 of the Companies Act, 1956

4 Section 208 the Companies Act, 1956

5 <http://nishithdesai.com/SectionCategory/33/Telecom-Hotline/12/27/TelecomHotline/5682/1.html>

6 This would be subject to Article 1.4(iii) of the UAS License which provides that management control of the Licensee Company shall remain in Indian Hands.

7 Article 5 of the UAS license provides that the government may amend the terms of the license if in the opinion of the government it is necessary or expedient to do so in public interest or in the interest of the security of the State or for the proper conduct of the telegraphs

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