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## Critical Analysis of Preferential Allotment of Shares: Determining its Uses and Abuses in Lieu of Recent Amendment in SEBI Regulations

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*Acquiring capital is one of the most critical tasks that any corporate entity has to successfully overcome to remain floating in this ever-competitive and dynamic market. Numerous alternatives are available to a company to raise capital per its requirements. Preferential assignment of shares allows for non-asset-based capital raising and is the most extensively utilised fundraising technique for businesses. The article discusses the Preferential Allotment of Shares, regulated by the Companies Act of 2013 and the Companies (Share Capital and Debentures) Rules 2014. The paper also discusses in-depth the procedure of allotment and the things to consider while opting for it; it also sheds light on the recent amendment to Securities Exchange Board of India (SEBI) Regulations<sup>1</sup> regarding preferential allotment. It also describes how promoters, directors, and majority shareholders abuse the procedure of preferential shares to serve their interests. In the end, the paper attempts to critically analyse the procedure's pros and cons and ultimately decide whether it is a suitable fundraising option or not.*

**Keywords:** *shares, capital raising, sebi.*

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<sup>1</sup> SEBI (Issue of Capital and Disclosure) Regulations 2018, ch V

## INTRODUCTION

Companies follow various methods to raise funds; they can issue various securities to their investors to fulfil their funding needs on a timely basis. While the issuance of securities represents an investor's stake in the firm, it is essentially an accumulation of rights and liabilities transferred to the investor during issuance or upon the happening of particular events or the firm's dissolution. Once the securities are offered to investors, they could change or modify the corporation's capital table. The capital table is a framework that depicts the total investment administered in a firm, broken down by the proportion of ownership retained by every stakeholder.

Equity-based securities, debt-based securities, and hybrid securities, a mixture of debt and equity-based securities, are the standard instruments firms offer during investment rounds. The type of instrument an enterprise intends to issue is heavily influenced by the firm's valuation as determined by several methods. The primary distinction between the issuance of equity and debt-based securities is the dilution of ownership by the firm's current shareholders. While the issuance of wholly equity-based securities results in instant dilution of current ownership, debt securities (if convertible) dilute the ownership later in the corporation's lifespan.

**If we talk about equity-based securities, the following are some of the preferred techniques/securities that corporations use to raise investments:**

1. **Initial Public Offer (IPO):** An IPO is the procedure by which a firm initially makes the shares it holds available to the general public via a listing on an accredited stock exchange.
2. **Further Public Offer:** A further public offer (FPO) is the procedure of issuing additional shares to the general public via the stock exchange.
3. Preferential allotment is the issuance of equity shares to a limited set of shareholders at a fixed rate.<sup>2</sup>

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<sup>2</sup> CS Prachi Jain, 'PREFERENTIAL ALLOTMENT OF SHARES | COMPANIES ACT,

## WHAT IS PREFERENTIAL ALLOTMENT OF SHARES?

The preferential allotment is the process of allocating equity shares to investors or members of a company on a preferential basis. In simpler words, we can assume that preferential allotment refers to the preferential distribution of equity shares to a specific number of shareholders at an agreed-upon rate. Corporations can opt for preferential allotment by adopting a special resolution at the firm's general meeting. It cannot, however, comprise securities or shares issued via public offerings, rights issues, bonus issuances, sweat equity share issuances, ESOPs, or depository receipts. It is the issuance of shares or convertible securities by an entity, whether listed or unlisted. As per Section 8 of the Companies Act 2013<sup>3</sup>, all firms, regardless of private or public, may engage in the preferential allotment of shares.

## PREFERENTIAL ALLOTMENT OF SHARES: RELEVANT SECTIONS

**Section 62 of the Companies Act 2013:**<sup>4</sup>This section talks about the issuance of additional share capital. The section recommends a set of individuals firms must reach out to for additional investments: individuals who, at the time of offer, possess equity shares of the enterprise. The company must propose via notice stating the number of shares offered; the time limit for acceptance should be a minimum of fifteen days and a maximum of thirty days; after that, the proposal will automatically cease to exist. A right to renounce the shares provided in favour of an individual, and if the individual rejects the offer, the company may transfer the shares to staff under the Employees Stock Option Plan (ESOP). The company can also transfer the rejected shares to any group of individuals permitted by a special resolution and who do not belong to the categories of people recommended by this section for such transfer. The notification must be issued to those persons via registered or speed post and any electronic form. The part does not cover debt instruments or loans from any firm, authorities, or banking institution.

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2013 | PROCEDURE' (*Tax Guru*, 01 November 2021) <<https://taxguru.in/company-law/preferential-allotment-shares-companies-act-2013-procedure.html>> accessed 14 January 2024

<sup>3</sup> Companies Act 2013, s 8

<sup>4</sup> Companies Act 2013, s 62

**Proddaturi Malathi v SRP Logistics Pvt Ltd Company Appeal (AT) 08/2018:**<sup>5</sup> In this case, the respondent was an incorporated private corporation with five lakh rupees as their share capital. The appellant was appointed as the assistant director in the corporation. In 2015, an announcement regarding a board of directors meeting was made. This meeting aimed to raise the share capital by thirty-five lakh rupees. Moreover, a general and board of directors meeting was held to issue shares in 2016. Then, in 2017, notification regarding an extraordinary general meeting was provided to everyone. This EGM aimed to dismiss the appellant from the director's position and discharge her of her duties in the firm. As a result, she approached a tribunal, which issued an interim injunction in her favour. She was dissatisfied with the ruling and contested the issue of shares, claiming that the corporation had breached Section 62<sup>6</sup> of the Act. The fundamental question in this case was if a breach of Section 62 of the Act had taken place and if the tribunal's ruling was proper. The Court noted that prior Section 62 did not apply to private entities. However, it is currently applicable and mandates the issue of shares be put forward first to current investors or shareholders of the corporation who already possess equity shares. They must be provided with the opportunity to decide whether to take the offer or turn it down, as well as the chance to renounce the proposal in favour of another individual, as specified in the provision. As per the registered valuer's report, shares shall be issued to any other person at a reasonable price. The appellant argued that the firm had already expanded its authorised share capital two times and paid capital three times since its incorporation. She even alleged the firm was doing so to minimise her share in the company and bring her status to a minority in the corporation. The appellant even argued that the tribunal's ruling did not address certain activities by the firm. The National Company Law Appellate Tribunal (NCLAT) stated that, under Section 62, shares must initially be presented to current shareholders and if they refuse or the proposal declines, it may be divided amongst others. The NCLAT thus directed that the issue be remanded to the tribunal so that it might consider the case on its merits and the other listed matters that had not yet been addressed.

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<sup>5</sup> *Proddaturi Malathi v SRP Logistics Pvt Ltd & Ors Company App (AT) 8/2018*

<sup>6</sup> Companies Act 2013, s 62

**Section 42 of the Companies Act 2013:**<sup>7</sup> The section specifies the offer or invitation to subscribe for securities in a private placement. It indicates that the offer will be made to a maximum of fifty people, eliminating measures for personnel under the Employee Stock Option under section 62(1)(b)<sup>8</sup>. For this section, a private placement is any offer of shares or proposal to subscribe for shares made by a corporation to selected individuals, subject to the compliance of the conditions mentioned in this provision. Payment must be done via demand draft, bank deposit or cheque rather than cash. Allocation of shares should happen within two months after receiving the subscription amount.

**Rule 13 of the Companies (Share Capital and Debentures) Rule 2014:**<sup>9</sup> The regulation specifies the rules and processes for issuing shares under Section 62<sup>10</sup>, read with Section 42 of the Companies Act of 2013. The shares must be offered when the board of directors has authorised them through a special resolution passed at a meeting. The preferential allocation has to be offered to a minimum of two members. A licenced valuer is not required to determine the selling price of a preferential issuance by a listed firm. The offer must be authorised by the Articles of Association (AOA) and approved by a special resolution at a board meeting. The board of directors must submit an explanatory statement outlining the details of the matter. The preferred allocation must occur within twelve months of the resolution's approval. Every proposal or application presented to allottees must clearly and fully indicate the share price. Convertible instruments are also included with the shares and securities. The firm's proposal has to incorporate a condition that specifies the approximate price of such conversion.

This regulation also defines Preferential Offer in the explanation: 'as an issue of shares or other securities, by a firm to any person or selected group of people on a preferential basis but does not include shares offered via a rights issue, public issue, sweat equity shares, ESOP, bonus shares etc.'<sup>11</sup>

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<sup>7</sup> Companies Act 2013, s 42

<sup>8</sup> Companies Act 2013, s 62(1)(b)

<sup>9</sup> Companies (Share Capital and Debentures) Rules 2014, r 13

<sup>10</sup> Companies Act 2013, s 62

<sup>11</sup> Companies (Share Capital and Debentures) Rules 2014, r 13(1) Expl

## PROCEDURE OF PREFERENTIAL ALLOTMENT OF SHARES

To understand the complete procedure of preferential allotment of shares, we need to closely understand Section 62 of the Companies Act 2013<sup>12</sup>, read with Rule 13 of the Companies (Share Capital and Debentures) Rules<sup>13</sup> and Section 42<sup>14</sup> of the same Act, read with Rule 14 of the Companies (Prospectus and allocation of Securities) Rules, 2014<sup>15</sup>. These sections specify the method and requirements governing the allotment of shares preferentially.

**1. Schedule the company's board meeting:** The notification of the Board of Directors Meeting must be provided to all shareholders seven days prior to the meeting, as mandated by Section 173 of the Companies Act, 2013<sup>16</sup>. The proposed agenda for the meeting must be provided in the notice. The notification must incorporate a draft resolution from the meeting.

**2. Conduct a Board Meeting:** Firstly, the meeting's attendance is confirmed. The Board of Directors then votes on a resolution to grant shares on a preferential basis, and the items that get addressed are as follows:

1. Valuation Report Assessment.
2. Specification of the total number of recipients.
3. Determination of the date, location, and time of the Extraordinary General Meeting (EGM).
4. Creating a draft of the offer letter.
5. Preparation of a formal notification of the EGM and the Explanatory Statement.
6. Acceptance of the resolution to approve the Offer Letter.
7. Authorising any Director to send out the notification of EGM.

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<sup>12</sup> Companies Act 2013, s 62

<sup>13</sup> Companies (Share Capital and Debentures) Rules 2014, r 13

<sup>14</sup> Companies Act 2013, s 42

<sup>15</sup> Companies (Prospectus and allocation of securities) Rules 2014, r 14

<sup>16</sup> Companies Act 2013, s 173

**3. Setting another bank account:** The firm must open another bank account in order to receive the payment for the shares scheduled to be allocated through preferential allotment.

**4. Notification for Extraordinary General Meeting:** The notification of the EGM, together with the meeting's plan of action, will be given to all shareholders, executives, and auditors of the firm. The written notice must be presented to everyone no later than 21 days prior to the EGM.<sup>17</sup>

**Conduct an Extraordinary General Meeting: First, the meeting's quorum is checked. The EGM is convened for the reasons outlined below:**

1. Provide the Letter of Offer in PAS-4 Form to every shareholder of the firm.
2. To approve a special resolution for the preferential share issue.

**5. Letter of Offer:** Once the EGM attendees pass the Special Resolution, the approved Letter of Offer will be communicated. The Letter of Offer comes along with a serially numbered application form issued specifically to the individual to whom the proposal of Preferential Shares has been made. The offer letter must be drafted or sent digitally within 30 days of the EGM as stated under Rule 14 (3) of the Companies (Prospectus and Allocation of Securities) Rules, 2014.<sup>18</sup>

**6. Submission of MGT-14 Application:** The Registrar of Companies must obtain the MGT-14 Application. The Form MGT-14 needs to be prepared and submitted within a month of the Special Resolution being approved at the EGM. The following attachments must be added to it:

1. The EGM notification, accompanied by a clarification.
2. The recorded statements from the Extraordinary General Meeting.
3. A legally certified copy of the Special Resolution adopted at the EGM.

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<sup>17</sup> Jain (n 2)

<sup>18</sup> Companies (Prospectus and Allotment of Securities) Rules 2014, r 14(3)

**7. Submitting Form GNL-2 to ROC:** After circulating the offer letter, Form GNL-2 must be submitted within 30 days to the Registrar of Companies. This form needs to be affixed to the following:

1. Letter of Offer in PAS-4 Format.
2. A full transcript of the private placement on the PAS-5 application stated under Rule 14 (4) of the Companies (Prospectus and Allotment of Securities) Rules 2014.<sup>19</sup>

**8. Second Board Meeting:** The notification for the second Board Meeting shall be sent a minimum of seven days in advance. The schedule for the Board Meeting must be included in the announcement of the Second Board Meeting. It must be convened within two months of receiving the Allotment funds. The purpose behind the meeting is as follows:

1. To display the names of all allottees.
2. To approve a Resolution for Share Allotment.
3. To approve a resolution for the issuance of share certificates to all investors.
4. To authorise any two Directors and a designated individual to execute the Share Certificates being provided to the investors.

## **WHAT ARE THE ESSENTIAL ASPECTS TO KEEP IN MIND WHEN ASSIGNING SHARES PREFERENTIALLY?**

The procedure for allotting preferred shares, stated under all the sections above-mentioned, includes a variety of factors to go through before being allocated by the firm to interested investors and members who seek to engage in the business. For carrying on with preferential allotment, the corporation must guarantee that:

1. The firm's Articles of Association must sanction the issuance of preferential shares as stated under Rule 13 (2) (a) of the Companies (Share Capital and Debentures) Rule, 2014.<sup>20</sup>

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<sup>19</sup> Companies (Prospectus and Allotment of Securities) Rules 2014, r 14(4)

<sup>20</sup> Companies (Share Capital and Debentures) Rules 2014, r 3(2)(a)



2. All prospective allottees must dematerialise their current equity shares in order to gain preferred shareholder status in the firm.
3. The special resolution required to pass an offer for preferential shares must be authorised by the corporation's current shareholders intending to issue preferential shares Rule 13 (2) (b) of the Companies (Share Capital and Debentures) Rule, 2014.<sup>21</sup>
4. The listed issuer gains access to the Permanent Account Numbers (PAN) of the prospective allottees, except for any of the allottees whom the Board of Directors might excuse from reporting their PAN while dealing in the stock market.

#### **PERSONS INELIGIBLE FOR PREFERENTIAL ALLOTMENT:**

1. If any promoter has earlier opted for the issuer's warrants but did not utilise them, then the promoter will not be considered for the preference shares.
2. Preference will not be given to individuals who have sold or traded their shares of the issuer six months before issuing the preference shares.
3. An issuer shall be ineligible for listing if the promoters or executives have committed financial offences and are now in the running.

The primary goal of setting such restrictions is to render it simpler for issuers to acquire money through preferential allotment while simultaneously ensuring that such issuance is not detrimental to the current shareholders' interests. In addition, I believe it simplifies and makes the overall preferential allotment process accessible and transparent to deserving investors.

#### **HOW TO SET THE RATE AT THAT SHARES ARE TO BE ALLOTTED?**

A registered valuer sets the value of shares distributed preferentially, keeping in mind the rules of the Companies Act of 2013. Furthermore, if any of the allottees is an individual residing overseas, the price specifications outlined in the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 would be applicable:

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<sup>21</sup> Companies (Share Capital and Debentures) Rules 2014, r 13(2)(b)

1. In the event of an unlisted firm, valuation is conducted using any globally recognised pricing technique and validated by a Chartered Accountant (CA), a Merchant Banker licensed by SEBI, or a licenced Cost Accountant.
2. In the event of a listed firm, the price is determined in compliance with the appropriate SEBI regulations.

## **ADVANTAGES OF PREFERENTIAL ALLOTMENT**

**Preferential share allotment benefits the organisation in several ways. The benefits of preferential allotments are as follows:**

1. The primary advantage is that power is not reduced. The preferential allotment is unlikely to result in power reduction because shareholders do not have the option to vote. Shareholders or investors receive interest and dividend payments but lack voting privileges or representation at board meetings. It benefits the firm and its executives since they will not feel obliged to limit their executive authority or split with other shareholders.
2. One of the primary benefits is that on the assets as well as capital, no fees are imposed. The preferential allotment includes shares and convertible instruments. In contrast to debt instruments, shares do not generate any levy on assets. Furthermore, it is not necessary for preferential allotments to put the assets at risk. Thus, it benefits both the firms and their existing investors.
3. Preferential allotments boost the company's funding capability. It lowers the debt-to-equity ratio by freeing up room for non-convertible bonds and credit.
4. Another benefit for the company's members and investors is that if the value of shares rises, investors and shareholders may turn their convertible instruments into shares and get dividends and further gains, as preferential allotment is a method for dealing with convertible securities. The dividends and earnings exceed the predefined and set interest rates on the securities or debentures. It is an excellent opportunity for everyone involved- current members and investors.

5. Some firms begin to operate exceptionally well following the distribution of shares preferentially. The rationale behind this might be the fact that they spent the money they received efficiently and focused on their weak aspects and the sectors where they are lagging. In addition, The author feel that if some knowledgeable investors with experience decide to fund them and get on board, then the firm will undoubtedly flourish as it will gain their massive expertise along with the funds.

### **SPECIFIC BENEFITS TO SHAREHOLDERS**

1. Since preferential allotment of shares refers to granting securities to preferred investors, it fosters confidence between these investors and the corporation providing them with the securities.
2. The corporation pays preference shareholders right away, without any brokerage costs associated with the transaction procedure, as opposed to regular shareholders. Such perks provide preference stockholders with an edge over others.
3. Preferential allotment of shares is primarily for the benefit of shareholders, who enjoy priority. Individuals may approach corporations as preferential shareholders if they want to buy reasonably priced shares rather than going to the stock exchange and purchasing shares at higher costs.
4. Furthermore, preference shareholders always receive preference from the corporation, and their principal investment is always protected. For instance, regardless of whether the firm declares bankruptcy, preference shareholders remain the priority in acquiring remuneration over regular shareholders.

### **DISADVANTAGES**

1. Shareholders' not having voting rights: A shareholder who puts funding through preferential allotments does not have similar voting privileges or shareholding as a general shareholder. Thus, it may deter them from investing their funds in such an arrangement. While it can be

advantageous for the business's operations to obtain substantial capital, it does not provide parallel benefits to the shareholders.

2. The firm can forego dividend payments in one fiscal year and pay them collectively to preference shareholders the following year, allowing it to ease up on its finances. Although it may benefit the firm financially, it tarnishes the company's reputation and image in the minds of its shareholders, even if they receive their whole payout in the coming year. As a result, it indirectly impacts the firm's public image, even though it can help the organization minimise its monetary constraints. So, suppose the firm applies for a loan again in the future. In that case, it may damage the creditor's impression of the company's history, resulting in the lender not authorising the requisite amounts.

3. The corporation grants preference shareholders numerous privileges, including rights to the firm's assets. For instance, if the firm ever declares bankruptcy, preferred shareholders will never incur a loss as the corporation must prioritise them over other investors while offering compensation.

4. An investor may choose between preference and ordinary shares depending on his requirements. In my opinion, preferential allotment of shares has proven to be a very effective method of locking in funds for investors looking for minimal risks and a source of long-term investments. Since the shares are reasonably priced compared to share market rates, it has proven to be quite beneficial. Moreover, it mitigates risk as the investment poured in by traders remains shielded even during the bankruptcy of firms. Overall, I feel that these factors overshadow the few disadvantages that the procedure has. Therefore, even though preferential allocation has both benefits and drawbacks, it has proven to be one of the most suitable fundraising methods for a firm.

## **CAN THE PROCEDURE OF PREFERENTIAL ALLOTMENT BE ABUSED?**

Previously, when the Companies Act 1956 was in force, section 81(1A)<sup>22</sup> of the said act provided an opportunity for corporations to commence preferential allocation of shares by mandating it in a single special resolution of investors. The guidelines established by the Securities and Exchange Board of India (SEBI) governed such procedures as minimal cost, transparency, and lock-in of preferential shares given at the choice of investors seeking listing on the Share Market. According to allegations from the Press Information Bureau of India and SEBI, such preferred shares were offered excessively to those residing abroad and foreign nationals. Therefore, if this were the case, as per my understanding, it would have been disadvantageous for the experienced Indian investors who were eager to put in their resources and their expertise.

In addition, generally, promoters of companies have abused such methods, which is why promoters are currently barred from casting their votes on preferential allotment matters in many countries. In my opinion, it is essential since the promoter is an interested person in the entire procedure and if he retains a role that benefits him, it will be unjust to the other investors. There might be a lot of measures that could stop promoters or other corporate representatives from misusing their positions. One option may be to make the conversion necessary while offering warrants instead of shares to give the promoter additional time to gather funding. It would demonstrate the promoter's commitment to his business despite shifts in the market. In addition, the prospective conversion price may be linked to the current market level at the time of option execution. It would limit the promoter's profits by tying the conversion price to the market rate. Boosting the initial contribution and upping the cap from the current 10% may also provide excellent outcomes.

Many investors engage in unethical behaviour while using preferential allotment methods. They alter prices and attempt to control the share market. They even trade their ownership stakes at higher rates to maximise their earnings. Investors sometimes even issue shares to their relatives,

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<sup>22</sup> Companies Act 1956, s 81(1A)

which, in my opinion, provides them more authority over the firm's operations and makes it simpler to approve resolutions on vital issues and shape affairs suited to their preferences.

In addition, the investors or shareholders may attempt to spend the funds obtained via preferential allotment per their wishes. However, one should not exhaust every incentive acquired upon issuing the preferential shares since they must be allocated to the purposes stated at the general meeting of shareholders.

### **THE WAY FORWARD: SEBI 2021 GUIDELINES**

In a recent decision of December 2021, the Securities Exchange Board of India ('SEBI') decided, in a press conference, to ease the price criteria and lock-in conditions for obtaining money through allotment of shares and securities preferentially, making it simpler for corporations to raise capital. SEBI made these amendments to the Preferential Issue Regulations in the SEBI (Issue of Capital and Disclosure) Regulations, 2018 Chapter V. These amendments include:

1. The value of the shares allocated preferentially was earlier required to be higher than the average of the weekly high and low of the Volume Weighted Average Price ('VWAP') of shares on the share market throughout the earlier 26 weeks, or the VWAP throughout the 14 days prior the date of issue. SEBI has now reduced these time frames to 3 months and 10 days, stating the present time frames as too lengthy for establishing pricing considering fluctuations in the market.
2. Preferential issue shares are bound to a lock-in duration, and now SEBI has reduced the lock-in term from three years to 1.5 years (in case of issuance to promoters) and from one year to six months (in case of other cases) to align with lock-in requirements in the case of a public offering.
3. SEBI additionally made it obligatory to obtain a report of valuation from a registered independent valuer in the event of a preferential issue that results in an alteration in ownership or the allocation of over five percent of the issuer firm's post-issue fully diluted share capital to an allottee. Furthermore, such a preferential issue will now take place

only after receiving a reasonable proposal from the board composed of unbiased directors.

4. Finally, SEBI has permitted the offering of shares granted to promoters or promoter groups under a preferential issue within the lock-in period to fund the preferential issue's objectives.

In my opinion, this amendment represents a massive shift instead of simple routine alterations and increases security for minority shareholders. Under typical conditions, the ruling price reflects a company's valuation. The ruling price is the value for which a share was last traded, provided there was a greater or lesser bid. But, this could also give rise to numerous unaccounted difficulties. I feel that rather than adopting new valuation criteria, SEBI should look into alternatives that could make it simpler for enterprises to raise finances. For instance, if a firm fails to acquire money in line with the mandated valuation requirements, it must be allowed to do so with the consent of its ordinary shareholders instead of being barred from reaching them at all. Moreover, since they are fair and approachable, the present standards for judging preferential allotment perform effectively. Furthermore, SEBI has placed responsibility on the independent directors to initiate such transactions to offer a larger interest. Any preferential issue allocation resulting in a management change may be done simply under a planned proposal from a panel of independent directors. The report that recommends such allotment must address all aspects, including the value of shares. Overall, in my opinion, it is an admirable decision by the SEBI, and its effective execution will simplify and render the preferential share allotment system accessible and transparent to the members and shareholders.

## CONCLUSION

The Companies Act of 2013 and the accompanying rules regulate procedures for preferential allotment of shares. An individual with shares issued preferentially enjoys priority if and when the firm is winding up. The issuance happens at a fixed price. However, in my opinion, it may result in control being concentrated in a few hands because just a few individuals will acquire the shares, leaving the decision-making authority with majority shareholders, not the minority

ones. However, we can fairly assume that every practice has pros and cons; not every aspect can be good in practice. As per the detailed analysis presented above, we can be certain that the procedure of preferential allotment has undergone quite a few changes for its betterment and ease of procedural aspect, and by far, it is considered one of the most popular and advantageous fundraising methods.