Plugging loopholes in the Takeover Code: an analysis of the recent amendments

Introduction

The Securities and Exchange Board of India (**"SEBI"**) notified certain amendments to the SEBI (Acquisition of Shares and Takeovers) Regulations, 1997 (**"the takeover code"**) on November 06, 2009. These are called the SEBI (Acquisition of Shares and Takeovers) (Third Amendment) Regulations, 2009 (**"the amendment"**). The takeover code seeks to ensure investor protection and embodies various obligations of disclosure requirements and public announcements which are triggered when certain thresholds are crossed. An acquirer[1] may acquire shares or voting rights in a target company,[2] by himself, through or with persons acting in concert with him, and may continue to increase his shareholding gradually every year in accordance with the applicable provisions of the takeover code.

Impact of the amendment is visible not just on the aforesaid obligations but also in instances where acquirers acquire stake in a company by purchase of American Depository Receipts (**"ADRs"**) or Global Depository Receipts (**"GDRs"**) with voting rights beyond a certain threshold as well as by means of a creeping acquisition. This newsletter analyses the aforesaid changes introduced by SEBI as well as their consequential implications.

1. Acquisition of ADRs or GDRs

Chapter III of the takeover code comprises of regulations governing acquisition of shares, or voting rights or control in the target company. Prior to the amendment, acquisition of ADRs or GDRs was exempt from the provisions of Chapter III, unless the acquired depository receipts were converted into voting securities. Subsequent to the amendment, an acquisition of ADRs or GDRs is only exempt from regulations 10, 11 and 12[3] and not all the provisions contained in Chapter III, *provided* the acquirer of the depository receipts does not (a) become entitled to exercise voting rights on the underlying shares, or (b) exchange such depository receipts with the underlying shares carrying voting rights. Simply put, the code will apply in cases where voting rights are acquired regardless whether

[1] Regulation 2 (1) (a) defines acquirer as "Any person who, directly or indirectly, acquires or agrees to acquire shares or voting rights in the target company, or acquires or agrees to acquire control over the target company, either by himself or with any person acting in concert with the acquirer."

[2] Regulation 2 (1) (o) provides, "A listed company whose shares or voting rights or control is directly or indirectly acquired or is being acquired."

[3] Regulations 10, 11 and 12 enumerate the circumstances when a public announcement is triggered, namely; (i) on an acquisition of 15% or more shares or voting rights, (ii) acquirer, who holds between 15% and 55% shares or voting rights acquires shares, which shall enable him to exercise 5% or more of the voting rights in a target company , (iii) if an acquirer, who holds between 55% and 75% shares or voting rights, acquires any further shares or voting rights in the target company.(iv) a change in control over the management of the target company

the GDRs are converted to the underlying shares, and a consequential open offer via a public announcement will be compulsory.

In other words, as a consequence of the amendment, ADRs or GDRs carrying voting rights are effectively treated as equivalent to shares carrying voting rights.

Thus, earlier stakeholders could acquire majority stake in a company by acquiring ADRs or GDRs *(entitling them to voting rights in the underlying shares)* without the obligation of making a public announcement. With the amendment, acquisition of majority stake in such manner is no longer possible. Now, a mere entitlement to voting rights in shares underlying ADRs or GDRs can trigger the requirement of a public announcement, and prevent stakeholders from acquiring majority stake indirectly.

Indian companies looking to do fundraising through GDR listings with voting rights of 15% or more will attract the applicable obligations under the code. So, this mode of fundraising may potentially act as a deterrent as there is a time and cost factor associated with the open offer. The maximum stipulated time period permissible under the takeover code for completing the whole procedure beginning from the date of the public announcement till the final report is sent by the merchant banker to SEBI is 120 days. Practically, the entire procedure takes around 75 – 90 days, depending upon the efficiency of the merchant banker.

Moreover, usually it is very difficult to identify the acquirer of GDRs and often the depository administers the voting rights of the underlying shares. It is not clear how SEBI intends to identify the holders who will, collectively, trigger the threshold limits under the takeover code.

2. Creeping acquisitions *(clarifying the scope)*

It is important to discuss two other regulations of the takeover code. Regulation 10 prohibits any acquisition of shares by the acquirer, pursuant to which his shareholding along with persons acting in concert, if any, in the target company shall exceed 15% of the voting rights. Such an acquisition may only be made pursuant to a public announcement made by the acquirer.

Regulation 11 deals with consolidation of shareholdings. This regulation is targeted at two situations - firstly, where an acquirer holds shares between 15% and 55% and wishes to acquire further shares in the same company, and, secondly, where an acquirer who has acquired 55% or more but less than 75% of the shares or voting rights of a company still intends to increase its shareholding further.

2.1 Regulation 11 (1)

Regulation 11 (1) stipulates that an acquirer holding *(together with persons acting in concert with him)* between 15% and 55% shares or voting rights in a company, can acquire additional shares or voting rights *(entitling him to exercise more than 5% of the voting rights)* in any financial year, after making a public announcement.

The amendment inserted the words *"with post acquisition shareholding or voting rights not exceeding 55%"* in this regulation. This effectively puts a limit on the percentage of shares that may be acquired by means of creeping acquisition. Prior to the amendment, an acquirer could acquire less than the aforesaid 5% shares every financial year and avoid the obligation of a public announcement. In this manner, the acquirer could potentially keep increasing his stake each fiscal year and even cross the 55% mark as no limit had been laid down.

The amendment has now imposed an effective cap of 55%. An acquisition can no longer exceed 55% without a public announcement even if it is a creeping acquisition. A person holding 53% shares must stay below the 55% limit, and must necessarily make a public announcement when the acquisition has the effect of a shareholding above the prescribed cap of 55%.

2.2 Regulation 11 (2)

Regulation 11 (2) provides that an acquirer holding (*together with persons acting in concert with him)* between 55% and 75% shares or voting rights in a company, can acquire **any** additional shares with voting rights after making a public announcement. This was further revised in 2008 when an acquirer holding between 55% to 75% shares or voting rights was allowed to increase his shareholding or voting rights by 5% without the obligation of a public announcement provided two criterions were fulfilled.[4]

The amendment has inserted the words *"notwithstanding the acquisition made under regulation 10 or sub-regulation (1) of regulation 11"* in the second proviso. This non-obstante provision implies that regardless of an acquisition made by the acquirer under the aforesaid regulations, he can further enhance his shareholding with a 5% increase provided the two conditions (see footnote 4) are fulfilled.

The non-obstante provision has created an ambiguity with respect to the gradual increase, possibly circumventing the requirement of a public announcement as discussed below. Under regulation 11 (1), the acquirer can increase his shareholding up to 5% only once without making a public announcement in any financial year. But by modifying the proviso the regulator has opened the door for increasing the shareholding more than once in the same fiscal year.

In our opinion, SEBI needs to clarify whether an acquirer can increase his shareholding by 5% per the provisions of regulation 11 (1) and in the same financial year, by acquiring additional shares which will fall within the ambit of the second proviso to regulation 11 (2), he can further enhance his shareholding by another 5% without the obligation of a public announcement. If indeed the amendment has such an implication it will mean that an acquirer will now have the opportunity to increase his shareholding by nearly 10% in the same fiscal year.

[4] Firstly, the acquisition is made through open market but not through bulk, block or negotiated deal or preferential allotment and nor is the increase in the shareholding or voting rights a result of a buy back of shares of the target. .Secondly, following the increase the acquirer does not hold more than 75% shares or voting rights in the target company.

Conclusion

Although the amendment effectively treats ADRs or GDRs carrying voting rights at par with voting securities, SEBI needs to clarify how or when a depository receipt may be said to carry voting rights. Till now, cross-border acquisitions involving sale or purchase of ADRs or GDRs did not call for public announcements but pursuant to the amendment, this is no longer the case. Further, with the application of the takeover code to such transactions, compliance requirements for the acquirer will increase manifold having a possible impact on the transactional cost. Thus, companies engaging in international transactions will have to bear in mind, that transactions involving acquisition of ADRs or GDRs could potentially trigger the requirement of a public announcement. Hence, they must develop their strategies and deal structures accordingly.

The concept of creeping acquisition has also been impacted by the amendment. Again there is need for clarity regarding the amendment to regulation 11 (2), i.e., whether or not an acquirer will now be able to acquire up to 10% shares in a fiscal year without triggering the complex and time consuming requirement of a public announcement.

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