Changes in the Takeover Code: Raising the Bar of Indian M&A

Introduction

The market regulator, Securities Exchange Board of India (**"SEBI"**) introduced the SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997, commonly known as the Takeover Code, which established the fundamental rules for mergers and acquisitions. The Code was reviewed in 2002, mandating greater disclosures of holdings at every stage. With the evolving market conditions greater need was felt to change the regulations and align them with other global markets. So, within ten months of its constitution, a strong panel headed by Mr. C Achuthan submitted a fresh set of recommendations for takeovers. The changes which include increasing[1] the trigger limit for takeovers are bold and could be sweeping, when implemented.

The current newsletter provides an overview of the key important proposals and what that means for M&A in India.

Selected Key Changes

While it is not possible to get into the details of the 139 page proposals, but the key proposals cover the fresh triggers for an open offer, size of an offer, mode of calculating the offer price, indirect acquisitions, competing offers, timelines and suggestions for enhanced corporate governance.

1. **Open offer trigger and size of the offer:** The panel recommends hiking open offer trigger to 25% as opposed to the existing 15% and raised the offer size to 100% of the equity in the target company in case of a *statutory* open offer. This means an open offer will kick in only when an entity acquires at least 25% in a listed company. But, once a company crosses that mark it will also have to make an open offer to buy 100% of the company's shares. Under existing rules, buyers only need to make open offers for 20% after acquiring a 15% stake. Further, for a *voluntary* open offer, the minimum offer size would be 10% with a maximum being 75%.

The committee has also observed that the 100% open offer requirement could potentially result in an acquirer in holding beyond the maximum permissible non-public shareholding. According to a June 2010 amendment to the Securities Contracts (Regulation) Act, 1956 every listed entity is required to maintain a minimum public shareholding of 25%. According to the June 4, 2010 notification, promoters of companies that currently do not comply with this rule are required to bring down their stake by at least 5% every year till the promoter holding comes down to 75%.

[1] The existing regulations mandate that once a company acquires 15% or more of voting rights in a target company, it has to make a mandatory open offer for an additional 20% shares.

Disclaimer – This E-Newsline is for information purposes and should not be construed as legal advice. © PSA 2010

The panel's proposal to make an open offer for the entire 75% stake after the open offer trigger may lead to an acquisition of 100% stake by an acquirer, thereby triggering the delisting clause. In such a case, the suggestion of the panel is that the acquirer can either opt for delisting or reduce its holding to meet the continuous listing requirements. The acquirer would have to state upfront his intention to delist if his holding in the target were to cross the delisting threshold, pursuant to the open offer. If delisting is triggered and there is no such disclosure, the acquirer would be required to either proportionately reduce both its acquisitions under the agreement that triggered the open offer and the acquisitions under the open offer or to bring down his holding to comply with continuous listing requirements. This option is not available as the regulations stand at present.

However, no changes are put in the offing in the creeping acquisition norms, except that the upper limit has been suggested at 75% instead of the present 55%.

2. **Mode of calculation of the offer:** The panel has proposed that the offer price would be the highest of **(i)** market price to be based on 12 weeks volume weighted average of market prices as against higher of weekly averages of market prices for 26 weeks or 2 weeks; **(ii)** a qualitative improvement and expansion in the look back provision; **(iii)** in the case of indirect acquisitions, ascription of value to the target company under certain circumstances.

3. **Non-compete fee:** Usually, a non-compete fee is paid by the acquirer to the promoters and such payments could be as high as up to 25% of the transaction value. To provide greater transparency, another important suggestion is that the non-compete fee of up to 25% of the deal size to the seller, where promoter sellers are typically paid more than the other shareholders to prevent them from the starting the same business again, must be avoided. This means that any kind of non-compete fee or control premium paid to promoters will have to be factored in while calculating the open offer price for the minority shareholders. Should this be passed, the promoters will no longer get huge sums of money from the acquirer for abstaining from competing. It will be interesting to see corporate India's reaction to this provision as generally this is one of the toughest part of the negotiations.

4. **Timelines:** The committee has also recommended that a short public announcement should be made by the acquirer on the date of entering in to an agreement followed by a detailed public statement within five business days thereafter. The overall timeline for an open offer has been brought down from 97 days to 57 business days. If approved, companies will now have to make a public announcement of the open offer on the same day as the shareholder agreement.

5. **Better corporate governance:** The committee has made an endeavor to improve the corporate governance norms by suggesting that it should be mandatory for the independent directors of the target to give their recommendation on the open offer. In an increasing focus on compliance and greater focus on collective good for stakeholders, this is indeed a welcome move. As is well-known, Indian companies are very promoter-centric and the "control" vests in a closed inner coterie. Moreover, the proposals provide that the acquirer could not appoint its nominees on the board of directors of the target unless 100% of the consideration under the open offer is placed in an escrow account. Further, any material transactions outside the

Disclaimer – This E-Newsline is for information purposes and should not be construed as legal advice. © PSA 2010

ordinary course of business cannot be undertaken during the offer period without approval of shareholders of the target company.

6. **Impact on ADRs and GDRs:** The existing rules on triggering an open offer would apply to entities acquiring Global Depository Receipts or American Depository Receipts with voting rights in an Indian company. Currently, there is a provision which exempts GDR and ADR holders from the requirement of making a public offer. Now, if the ADR/GDR holders also acquire voting rights, then they would not be entitled to the benefit of the exemption. Thus, the panel has tried to remove the ambiguity surrounding the open offer regarding GDR/ADR holders.

Conclusion

As on date, the recommendations are open for public feedback until August 31, 2010 when SEBI will take a final call. Clearly, by trying to create a level playing field, the panel has made a concerted effort to ensure equality of opportunity and fair treatment of all shareholders. Minority shareholders will, hopefully, stand to gain from the changes which will enable them to participate in the acquisition process, once the suggestions will be implemented. It is hard to predict what the impact will be on the size and flow of M&A activity in the country. Investors will definitely be allowed to take strategic stakes. But, assuming that the proposals see the light of the day several questions arise - what is the likely implication on deals in the pipeline? Will it be easy to procure financing for funding the acquisitions? Is the regulator equipped to handle and adhere to the reduced time line of 57 days? Has acquiring an Indian company suddenly become more expensive? Answers are not easy, and change brings its own level of discomfort for those safely ensconced in their cushioned zones. But, the panel certainly deserves to be lauded for introducing some of these much-needed proposals which will minimize the possibilities of manipulation. Time will tell.

Authored by:
Priti Suri

Disclaimer – This E-Newsline is for information purposes and should not be construed as legal advice. © PSA 2010