Corporate Finance/M&A - India

Securities Exchange Board introduces amendments to the Takeover Code

Contributed by **PSA, Legal Counsellors**

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Introduction

The Securities Exchange Board introduced the Substantial Acquisition of Shares and Takeover Regulations in 1997 - commonly known as the Takeover Code - which established the fundamental rules for mergers and acquisitions. The code was reviewed in 2002, mandating greater disclosure of holdings at every stage. With market conditions evolving, it was felt that the regulations needed to be amended to align them with those of other global markets. Within 10 months of its constitution, a panel (headed by Mr C Achuthan) has 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.

Key changes

Open offer trigger and offer size
In case of a statutory open offer, the panel recommended increasing the open offer trigger to 25% (as opposed to the existing 15%) and raising the offer size to 100% of the equity in the target. This means that an open offer will kick in only when an entity acquires at least a 25% share in a listed company. However, once a company crosses that threshold it will also have to make an open offer to buy 100% of the company's shares. Under existing rules, buyers need to make open offers for only 20% after acquiring a 15% stake. Further, for a voluntary open offer, the minimum offer size would be 10%, with the maximum being 75%.

The committee also observed that the 100% open offer requirement could potentially result in an acquirer holding more than 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%. Company promoters which currently do not comply with this rule are required to reduce their stake by at least 5% every year until their holding comes down to 75%.

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

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

Mode of calculating the offer price
The panel has proposed that the offer price would be the highest of:

- the market price to be based on 12 weeks' volume weighted average of market

- prices as against higher weekly averages for 26 weeks or two weeks;
- a qualitative improvement and expansion in the look-back provision; or
- the ascription of value to the target under certain circumstances (in the case of indirect acquisitions).

Non-compete fee
Usually a non-compete fee is paid by the acquirer to the promoters; such payments can 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%, where promoter sellers are typically paid more than the other shareholders to prevent them from starting the same business again, be avoided. This means that any kind of non-compete fee or control premium paid to promoters will have to be factored in when calculating the open offer price for the minority shareholders. Should this be passed, the promoters will no longer receive huge sums of money from the acquirer for abstaining from competing. It will be interesting to see the reaction to this provision, as generally this is one of the toughest parts of the negotiations.

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

Better corporate governance
The committee has endeavoured to improve corporate governance norms by suggesting that it be mandatory for the independent directors of the target to give their recommendation on the open offer. Given the increasing focus on compliance and on the collective good for stakeholders, this is a welcome move. As is well known, Indian companies are promoter-centric and the 'control' vests in a closed inner coterie. Moreover, the proposals provide that the acquirer cannot 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 ordinary course of business cannot be undertaken during the offer period without approval by the target's shareholders.

Impact on GDRs and ADRs
The existing rules on triggering an open offer apply to entities acquiring global depositary receipts (GDR) or American depositary receipts (ADR) with voting rights in an Indian company. There is an existing provision which exempts GDR and ADR holders from the requirement to make a public offer. Under the amended code, if the GDR/ADR holders also acquire voting rights, then they will not be entitled to benefit from the exemption. Thus, the panel has tried to remove the ambiguity surrounding open offers regarding GDR/ADR holders.

Comment

The recommendations are open for public feedback until August 31 2010, at which time the board will take a final call. By trying to create a level playing field, the panel has clearly made a concerted effort to ensure equality of opportunity and fair treatment of all shareholders. Minority shareholders stand to gain from the changes, which will enable them to participate in the acquisition process once the suggestions are 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.

Assuming that the proposals see the light of day, several questions arise. What is the likely implication on deals in the pipeline? Will it be easy to procure financing to fund the acquisitions? Is the regulator equipped to handle and adhere to the reduced 57-day timeline? Has acquiring an Indian company suddenly become more expensive? The answers are not easy to find, and change brings its own level of discomfort for those safely ensconced in their comfort zones. However, the panel certainly deserves praise for introducing these much-needed proposals which will minimise the possibilities of manipulation.

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Endnotes

(1) The existing regulations mandate that once a company acquires 15% or more of the voting rights in a target, it must make a mandatory open offer for an additional 20% of the shares.