Amendment to Takeover Regulations: SEBI Walks a Balanced Path

Introduction

The capital market regulator, Securities Exchange Board of India (**"SEBI"**), has been expressly mandated to regulate substantial acquisition of shares and takeover of companies in India. In its stride to do so, it came out with first set of regulations governing takeovers in 1994, which were overhauled in 1997 and notified as SEBI (Substantial Acquisition of Shares and Takeover Regulations), 1997 (**"Takeover Regulations"**). Since then, it has stood 23 amendments, till Takeover Regulation Advisory Committee (**"TRAC"**) headed by Mr. C Achuthan proposed revamping of almost the entire Takeover Regulations (**"Draft Regulations"**) on July 19, 2010.[1] TRAC made some striking recommendations, for instance the increase in "offer size" to 100%.[2] The Draft Regulations were open for public comments till August 31, 2010 and SEBI, almost after a year has recently in its board meeting approved most of the recommendations given by TRAC.[3] But strictly speaking these approved changes would have legal force only after SEBI notifies and issues an amended copy of the Takeover Regulations.

The current newsletter provides an overview of key changes approved by SEBI vis-à-vis the Draft Regulations, highlighting its impact on M&A activity in India.

Key Changes

The exact implication of the changes would be clear once SEBI comes out with the fine print of the amended Takeover Regulations. It has approved some of the proposals given by TRAC absolutely, some partially and have rejected others upfront. The important ones are discussed below from the perspective of an initial understanding:

1. Absolutely accepted proposals

1.1 Trigger point

The trigger limit for making an open offer has been increased from the existing 15% to 25%. This is in consonance with the recommendation given by TRAC and brings India on par with similar thresholds globally wherein most developed jurisdictions the trigger limit is between 30-35%. The threshold has been appropriately placed at 25%, paying heed to fact that a shareholder acquires the veto right to block a special resolution above this limit under the Indian Companies Act, 1956 (**"Companies Act"**). A special resolution is to be passed by a majority of at least three-fourth shareholders in a general meeting. Such a resolution is

[1]For analysis of the Draft Regulations, see Changes in the Takeover Code: Raising the Bar of Indian M&A (2010) available at http://www.psalegal.com/upload/publication/assocFile/ENewslineJuly201007262010012403PM.pdf.

[2] Takeover Regulations mandates an offer size of at least 20% in case an acquisition triggers open offer requirement.

[3] See SEBI Press Release No. 119/2011 dated July 28, 2011.

required for several important corporate actions including alteration of the provisions of the memorandum, change in objects and name of the company, reduction of share capital, etc. But often this threshold may give rise to operational difficulties in a company, if the acquirer decides to oppose any special resolution. In this situation it would become an arduous task on part of promoters to get all other shareholders vote in favour of the resolution.

This increase of 10% would provide assistance to companies in attracting funds from strategic/financial investors, and gives some respite in wake of current upward interest rate regime in the country. It also provides more headroom to private equity investors for larger investments without getting indented by public offer requirements. But at the same time it is pertinent to note that a threshold of 25% would make companies (including some large corporate houses) with substantially low promoter shareholding more vulnerable to hostile takeovers.[4]

1.2 Non–compete fees

The extant Takeover Regulations provided a leeway to pay non–compete fee as high as 25% of the whole transaction value to the promoters of a company. This control premium to promoters is a part of most M&A transactions. SEBI has now decided to dispense the provision for non-compete fees as per the recommendation given by TRAC. This is based on the rationale of equitable treatment to all shareholders in a company. The TRAC report suggested that any such consideration paid should be added to the negotiated price per share for the purpose of determining open offer pricing. In case the parties decide to do so, it would be good news for public shareholders but at the same time would make acquisition costlier for the acquirer. Getting rid of the non–compete amount altogether from the open offer price may not be acceptable to the promoters. Such an option may also not be commercially viable as most of the businesses in India are family owned and promoter run, where they contribute substantially to the enterprise rather than just being in realms of management. Thus, in our view outright scrapping of the provision of non–compete fee is not prudent, especially in instances where takeover is of a business involving real personal contribution by promoters.

1.3 Voluntary & Competing offers

The Takeover Regulations contains limited provisions with regard to voluntary open offers for the consolidation of holdings in a company. TRAC recommended for a separate provision for voluntary offer of a minimum 10% of the voting rights in a company. Draft Regulations mandated that such a consolidation can only be availed by an acquirer holding shares entitling them to exercise at least 25% or more voting rights in a company. Furthermore, an acquirer using this provision cannot transgress the minimum public

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[4] The TRAC report highlighted that there are around 600 companies where promoter shareholding is below 25%. Even in a big corporate giant like Infosys Limited, the percentage of promoter shareholding on March 31, 2011 is just 16.04% of the total share capital of the company. The same is reflected in audited financial results of the company available at http://www.infosys.com/investors/reports-filings/quarterly-results/2011-2012/Q1/Documents/Q1-2012-AD.pdf. On papers, the changes as approved by SEBI may even allow a potential acquirer to takeover Infosys and get a controlling stake of 51%.

shareholding requirement.[5] SEBI has approved voluntary offers subject to certain conditions, which have not been mentioned in the press release. In the absence of a blueprint of the amended Takeover Regulations, it has to be seen whether SEBI imbibes the same conditions as provided in the Draft Regulations or put forth some more onerous ones. It is also pertinent to note that the right of the acquirer to increase his shareholding through "creeping acquisition" provision still subsists and is available in spite of this new voluntary offer provision. Creeping acquisition allows an acquirer to increase his shareholding by 5% of the voting rights in a company in a financial year without being required to make an open offer.

The Takeover Regulations provide for competitive offers within 21 days of public announcement by the first acquirer. Draft Regulations included a new provision which empowers an acquirer to acquire the shares tendered in favour of competitive acquirers. This is to be done within 21 business days after the expiry of the offer period and at the same price as has been offered to public under the open offer. SEBI has approved this proposal but has used the word "successful bidder" in the press release. This word is neither used nor defined in Draft Regulations and the time period to complete such acquisition after the offer period is also unclear.

1.4 Recommendation by board of Target Company

Takeover Regulations provides an option to the board of directors of the target company to make an unbiased recommendation or comment on the open offer. TRAC in consonance with similar provisions in other jurisdictions had recommended making it mandatory for independent directors on the board of the target to give a reasoned recommendation on the open offer. SEBI has accepted this recommendation and it would certainly help public shareholders with greater insight to make a reasoned decision. But at the same time this may give rise to conflict of interest issues, as to the level of participation of directors and disclosure of their interest, if any, in case they hold shares in the target company.

2. Partially accepted proposal

2.1 Open offer size

One of the most striking recommendations under the Draft Regulations was to increase the open offer size to 100% from 20% provided under the Takeover Regulations. The rationale as explained by TRAC was to create a level playing field and give an equal opportunity to "exit" from the company to both the public shareholders and the promoters. SEBI partially approving it has marginally increased the offer size to 26%. This is on account of stiff opposition and lobbying from Indian corporate houses, as it would have made the whole process costly for them. Also, as banking laws in India restrict banks from funding

[5] Securities Contracts (Regulation) (Amendment) Rules, 2010 dated June 4, 2010 mandates a listed company to maintain a minimum public shareholding of 25%.

acquisitions,[6] it would have created disparity between Indian acquirers and foreign acquirers (who have better and cheaper access to capital).

This increase of 6%, fails the whole rationale of TRAC recommendations, as the minority stakeholders would still be entitled to only a limited "exit" gateway. Moreover, it is important to note that technically an acquirer can now acquire controlling stake of (20% + 26% through open offer) 51% in the company. This can reduce the public float and liquidity in the market with shares being concentrated in few hands.

3. Rejected proposals

3.1 Control

TRAC had recommended enlarging the contours of the definition of "control" to include "ability" along with "right" to appoint majority of directors or control the management or policy decisions. Thus an attempt was made to include *de facto* control, rather than just *de jure* control to trigger open offer obligations. Draft Regulations had also clarified that just by virtue of being a director or officer of the company, a person ought not to be in "control" of the company. SEBI has decided to retain the existing definition of "control", and thus "right" to appoint majority of directors or control the management or policy decisions would remain the parameter to adjudge the control exercised by an acquirer in the company.

3.2 Auto-delisting

In keeping with the recommendation of 100% open offer size, Draft Regulations also provided an "auto delisting" window for an acquirer, in case pursuant to the open offer he along with person acting in concert exercised voting rights in a company beyond the "delisting threshold".[7] To exercise this option, the acquirer had to also state their delisting intentions upfront at the time of making the public announcement. SEBI has probably rejected this proposal as the approved offer size of just 26% would not normally trigger delisting. Additionally, such a provision under the Takeover Regulations would have circumvented the express reverse book building process prescribed under the Delisting Regulations.

Conclusion

Overall taking a calibrated approach, SEBI has tried to please all the constituents involved in a takeover process. Though the changes approved are not as radical as proposed by TRAC, it would certainly be a game changer for both the acquirer and the targeted

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[6] Regulations in India state that promoters' contribution towards the equity capital of a company should come from their own resources and the bank should not normally grant advances to take up shares of other companies. See Para 2.3.1.6, Reserve Bank of India, Master Circular-Loans and Advances-Statutory and Other Restrictions, dated July 1, 2011.

[7] SEBI (Delisting of Equity Shares) Regulations, 2009 (**"Delisting Regulations"**) prescribes a "delisting threshold" of 90 % of the total issued shares (excluding the shares which are held by a custodian and against which depository receipts have been issued overseas).

company. From the perspective of minority stakeholders, the abolition of non-compete fees provides some respite, but still they may feel left out on account of marginal increase in the offer size. In any case SEBI has at least rested some uncertainty hovering over legal and regulatory framework of the country[8] by approving most of the year old recommendations given by TRAC.

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[8] Legislations like Companies Bill, Goods and Services Tax Bill, Direct Tax Code etc. are pending, and once approved would impact the industry in a big way. Moreover, Competition Commission of India has recently assumed a new regulatory role under CCI (Procedure in regard to transaction of business relating to combination) Regulations, 2011, but still there are varied apprehensions on the effect it would have on M&A activity in India.