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Regulators need a pragmatic view to encourage investments

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The Sebi (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 ("Code") has periodically undergone amendments. Quite justifiably so, since the Code provides the plinth on which balance is sought to be achieved between the often conflicting interests of acquirers and other stakeholders. Some of the parameters and thresholds that the Code prescribes find basis on the nascent market dynamics and economic reality that existed when the Code was being conceptualised.

Accordingly, the present day market with appreciable depth merits an overhaul of some of those aspects. It is consequently timely, that the regulator has set up Takeover Regulations Advisory Committee, a specialised body with a mandate to identify the best practices and put to rest some of the identified lacunae in the Code. This article seeks to highlight certain key concerns that need to be addressed.

'Promoter', includes a person in control of or who is identified as such in an offer document or shareholding pattern of the company. It is not uncommon for private equity (PE) investors to go through the hassles of getting classified as promoters of the company just by virtue of the block of shares they hold. PE investors add value, enhance governance and in most cases, have no intent to exercise day-to-day management control. Classification as promoters comes with a fair degree of risk and few drawbacks like ineligibility to participate in certain kinds of buyback, delisting offer, etc.

Hence, similar to FIIs, an exemption should be granted to PE investors from getting classified as promoters merely by virtue of their shareholding. This can be achieved by identifying PE investors as 'Financial Institution' in Regulation 2(1)(h) of the Code.

Globally, strategic investors protect their economic interest and downside through certain veto rights (board nomination, powers to block certain corporate actions, 'tag along', 'ROFR', etc.) and by entering into customary shareholders agreement with the company and promoters. Under the Code, such veto rights and agreement may carry a risk of such investor getting classified as a person in 'control' over the company or a 'person acting in concert' with the promoters. Having veto rights should not per se constitute control.

Hence, a clear distinction needs to be made between veto rights which are mere downside protection rights and those rights which enable investors to control the management and processes of the company. This can also be achieved by a more objective definition of the term 'control' under the Code.

However, mired with ambiguities and frequent changes on regulatory position are the types of corporate transactions that trigger open offers. Open offer, from a takeover perspective, means making an offer to acquire additional shares from the existing shareholders of the company concerned. Events that trigger making an open offer include exceeding certain shareholding thresholds whether through active equity acquisitions or even through other transactions where no wilful steps are taken to increase shareholding such as a company buyback etc.

The obligation to make an open offer under the Code has currently been pegged to shareholding of 15%. Practically, a 15% shareholding will not even give a negative control to the acquirer over the company since the minimum shareholding to block a special resolution under the Companies Act would be more than 25%. Hence, factoring the change in business landscape, it is high time that this threshold is re-visited and increased to a more reasonable one (say 26% or 30%). Further, this will bring the threshold on par with the comparables internationally — 30% in the UK and 35% in Hong Kong, just to name a few.

As contrasted from active acquisitions, equity buybacks lead to an involuntary increase in the percentage shareholding of shareholder(s) not participating in the buyback and thereby triggers the open offer. Being aware of this situation, Sebi has, on various past occasions, issued specific exemption from such open offer. However, such application is not without a cost and is a time-consuming process. Recently, the Code has been amended to grant an automatic exemption from an open offer for such involuntary increase pursuant to buyback, where the investors are already holding more than 55% shareholding. It is right time that such an automatic exemption should be extended to even those investors holding shares in the range of 15-55%.

Clearly, the market for takeovers, substantial acquisitions and consolidations is a maze of complex dynamics paired with conflicting interests of the participants. The Code has undergone series of phased changes that were primarily protectionist in outlook and geared towards bringing greater transparency. While it is important for the regulators to protect the interest of minority shareholders, it is equally important to ensure that the laws are not too unwieldy to discourage strategic investors. Practically, it may not be possible to resolve every ambiguity. However, given the financial reality of the times, the regulators need to take a more pragmatic view on some of the key issues to bring about certainty in the position of law and ultimately, encourage investments into India.

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