

# THE ECONOMIC TIMES

SEBI norms may foil promoters' stake sale tricks

5 Oct 2009, 0349 hrs IST, Sugata Ghosh, ET Bureau

MUMBAI: The tricky issue of promoter control will resurface in Corporate India for firms which are listed on overseas stock exchanges.

Recently, the capital market regulator, SEBI, tweaked the rules to bring ADR/GDRs — securities or foreign depository receipts issued to overseas investors against stocks issued by Indian companies — under the takeover code. The rule, however, applies to ADR/GDRs where the holders of the securities are entitled to exercise voting rights on the shares underlying the receipts.

What this simply means is that any foreign investor holding ADRs/GDRs with voting rights will have to make an open offer to public shareholders, if the holding touches the 15% limit — just as it applies to any local investor buying shares in the local market.

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But the new rule has left a lacuna for ADR/GDRs where the voting right is not in favour of the holders of the receipts. Many companies have issued ADR/GDRs where the voting right is tilted in favour of the management. In such cases, the custodian bank, which is holding the actual shares, votes at the instruction of the management. This is a gap that promoters and managements of companies issuing ADR/GDRs can use to their advantage to gain extra control. For instance, a promoter with a 30% equity holding, can use the voting right on the 20% block of GDR/ADR shares to sway all decisions.

According to sources in the financial market and a cross-section of experts on securities law, this strange practice, where the custodian bank votes in accordance with the board of the company, will now come under regulatory glare.

“If an ADR/GDR holder can be required to make an open offer for acquiring the voting rights then why the promoters should not be asked to do so where they breach the threshold limit of 5% for consolidating their voting right. The proposed change is likely to make the things more complicated,” said RS Loona, former SEBI executive director (legal affairs) and managing partner of Alliance Corporate Lawyers. Mr Loona felt that the regulator may have to look into this issue.

While it's difficult to say at what point an open offer will be triggered, the voting right that the custodian exercises on the block of shares can be conveniently used by promoters to approve or block certain resolutions. “If the custodian acts on the board's direction, the question that crops up is who controls the board. It's often perceived that in most companies, promoters have a significant control over the board,” said a person familiar with the subject.

As per the local listing agreement, a company with an executive chairman must have at least half the number of board members as independent directors. But where the chairman is a non-executive, independent directors can comprise only one-third of the board strength, while two-third of the board can be promoter nominees. “...One could argue that a company which the board represents is distinct from the promoters and, hence, it cannot be viewed as promoters indirectly acquiring more voting rights under

this arrangement,” said Siddharth Shah, who heads the corporate and securities practice at law firm Nishith Desai Associates. “But allowing the depository to vote according to instructions given by the board could be perceived as giving existing promoters effectively more control,” he said.

Indeed some years ago, RBI had raised this issue in connection with ADR/GDR offerings of Indian banks. These banks were told to change the arrangement between the board and custodian for exercising the voting right. But for majority of corporates, which are neither regulated by RBI nor have a cap on voting rights like banks, the practice continued. Today, it's likely to be questioned. According to H Jayesh, founder partner of the law firm Juris Corp, “The aspect of exercise of voting rights as regards ADRs/GDRs, including the ability to indirectly control their exercise, needs to be completely reviewed; not just in the context of the takeover code.”

It may be argued that giving promoters effectively more control should not automatically trigger an open offer as this may not result in ‘change in control’ for the purpose of regulation 12 of the code. “But, while it may not trigger an open offer, the custodian vote can be used to influence certain resolutions,” said Mr Shah. For instance, a hostile takeover.

Since the exercise of voting right is a material development, the ADR/GDR issue prospectus cannot be silent on the subject.

Interestingly, a related issue that may come up relates to treatment of ADR/GDR holders for the purpose of calculating the public shareholding in a listed company. “Currently, they are excluded for this purpose. Now, if they are required to make open offer then they will have to be considered for the purpose of determining the level of public shareholding in a company. This will call for review of clause 40A of the Listing Agreement,” said Mr Loona.

The question of an indirect control exists as long as depository receipts are not converted into shares. These receipts are transferable instruments which can be freely traded on the exchange on which they are listed. They are also fungible, which means the holder of ADRs can instruct the depository to convert them into underlying shares and offload them in the Indian market.

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