Decoding the "Takeover Code"

SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997

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This article provides a quick yet comprehensive overview of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997 (SAST Regulations or the Takeover Code). The article is meant for students of professional courses or anyone interested to grasp the essence of the Takeover Code.

Intent of the Regulations:

Before we understand any regulation, it is necessary to track its "jurisprudence", that is, the intent that the lawmakers are trying to achieve. In our interaction with hundreds of students, we ask – what is the purpose of the Takeover Code. We get numerous answers – for example, to protect the company from hostile takeovers, or to ensure that the company is not kept in dark when someone is taking over the shares in the company. These answers may not be wrong, but they miss the essential point. For example, protecting a company from a hostile takeover is not the purpose of the Regulations, as what is hostile to the existing management may be good for the majority of the shareholders. Also, keeping the company informed about transactions in substantial chunk of shares is not the main purpose – that is incidental to main objective. The main purpose of the Takeover Code is to ensure that when substantial number of shares change hands, that is, one group sells a controlling block of shares to another, the minority shareholders also get the opportunity to sell their shares at the negotiated price. If that was not the case, an existing group, say A, would sell the controlling stake to another group, say B, and the common shareholders simply continue to hold the shares without getting the right to participate in the sale that happened. A counter argument may be – the common shareholders may always sell their shares in the open market. But then, remember that when a controlling block gets transferred, the price paid is usually much higher than the prevailing market value, as such price includes the price for control too. There is yet another reason in giving the common shareholders the open offer –that if they so wish, they may exit the company as there is a change of guard happening in the company.

So, the crux of the Takeover Code is public announcement of a "substantial" acquisition, followed by an open offer for buying a certain minimum of public holdings.

Key concepts:

In understanding the Takeover Code, it is important to understand the following terms:

- **Acquirer** is the person (s), who, with or without **persons acting in concert**, acquires or agrees to **acquire control** over a **target company**.

- **Target company** is the company whose control is being acquired.
- The applicability of the Code is attracted where **control** is being **acquired**. "Control" may be acquired either by acquisition of a substantial percentage of voting shares in the target company, or by acquisition of management control. We discuss below the percentage of shares that is treated as "substantial" to attract the applicability of the Code. We also discuss the meaning of acquiring management control to attract the Code.
- **Persons acting in concert (PACs)** are those persons who are collaborating with the acquirer in acquiring control. Note that when takeovers happen in practice, it may not just be one person or corporate house, but several persons or more than one corporate house may collaborate and act together in acquiring the shares of a company. That is why the definition of PACs had to be brought in. Shares acquired by the PACs are counted along with those acquired by the Acquirer, to see if such acquisition is "substantial" and hits the Code. Certain persons are deemed to be PACs (**Deemed PACs**) – that is, in that case, it is not necessary to establish collaboration or togetherness in an acquisition – if shares have been acquired by the Deemed PACs, then they are clubbed with the shares acquired by the Acquirer.
- **Open Offer** is the offer to buy a certain minimum number of shares from the public shareholders.
- Needless to emphasize, the Code is limited to acquisition of shares in listed companies only. However, indirect acquisitions, that is, acquiring control over an unlisted company, which leads to acquisition of control over a listed company, is also covered by the Code – see below.

Types of Takeover:

Textbooks often begin by distinguishing between a friendly takeover, hostile takeover or a bailout takeover, but we think that distinction is of little relevance in understanding the Code. In fact, what is much more important is to understand:

- Takeover by Outsiders
- Takeover by Insiders
- Takeover by White Knight

Most significantly, one must note that takeover does not necessarily mean takeover by someone who is not currently in the controlling position of the company. That is to say, even if the current promoters, holding significant shareholding in the company, increase their holdings beyond a certain limit (Takeover by Insiders), then also the provisions of the Code are hit. Likewise, if someone not currently holding substantial equity in the company, buys a substantial chunk (Takeover by Outsiders), the provisions of the Code are hit. Takeovers are sometimes like battle for corporate control – if A is currently holding controlling stake, B buys a substantial chunk from the market and makes an Open Offer, it may be such that a competing acquirer C emerges who also makes an open offer. C may be either wanting to help A, or may be an acquirer in his own right.

So, what is acquisition of "control"?

The trigger point for the Code is (a) acquisition of control or (b) substantial acquisition. These two are not necessarily the same, because a substantial acquisition may arise even where there is no change in control. So, the trigger points for applicability of the Code are as follows (note that while counting any of the percentages below, we will count together the holdings of the PACs):

(a) **Acquisition of 15% voting rights:** On acquiring shares/voting rights which (taken together with shares or voting rights held by him or by PAC), entitle him to exercise **15% or more** of the voting rights in the Target Company. Thus, the trigger point is acquisition of 15% shares in the company. This is how acquisition under this route would normally happen – a potential acquirer would either slowly build a stake in the company adding up to 15 % (note, however, the information requirement below) or buy a substantial chunk from someone (commonly called "negotiated takeover"). Once the holding crosses 15%, the Open Offer requirement is triggered. That is, the acquisition of the excess over 15% is subject to the Open Offer.

(b) **Consolidation of holdings**: The Code applies even if persons holding substantial stake currently acquire further shares, beyond a limit. This is applicable to persons holding 15% -55% stake in the equity of the company. The limit upto which shares may be bought in a financial year is 5% - that is, not more than 5% equity shares may be acquired within a financial year. This is called "creeping acquisition" – so, if the acquisition of shares in a financial year crosses the limit of creeping acquisition, the Open Offer requirement is triggered.

(c) **Exceeding of holdings**: The Open Offer requirement is also hit if a person holding between 55 %- 75% acquires any further shares. This would mean a simple rule – in a listed company, no single shareholder group should hold excessive shares, as the widely-held nature of the company should be maintained (as an exception, there is one time opportunity for acquiring 5% equity shares in excess of 55%).

(d) **Acquisition of control with/without acquisition of shares**: The requirement of the Code is also applicable if control is exercised by any other means – for example, an agreement with the Target Company (usually incorporated in the articles of association) permitted the Acquirer to control the composition of board of directors of the Target, etc.

(e) **Indirect acquisition**: That is, acquiring control is an unlisted company, which has a controlling stake over a listed company. This part of the Regulation does not have any numerical limits of shareholdings, leaving the question to interpretation.

Information requirements:

The Code, apart from laying down the requirements of public announcement of a substantial acquisition and open offer (see below), lays a significant information requirement so that transactions in shares do not happen hush-hush.

The information requirements are applicable where the shareholdings cross limits of 5%, 10%, 14%, 54%, and 74%. The information is to be given by the acquirer to the company and the stock exchange.

In addition, any sale of shares of 2% or more is to be disclosed, if the seller holds 15%-55% stake in the company.

So what next, if there is acquisition of control?

If acquisition of control as above happens, there are primarily 2 requirements – public announcement, and open offer.

The public announcement is to put the company and the public to notice about a substantial acquisition that might have happened. The announcement is to be made within 4 working days of the acquisition, by a merchant banker, in all editions of an English daily, one Hindi daily, and one regional language daily. There are detailed contents of the public announcement given in Reg 16. The essence is to provide the shareholders and the public the identity of the acquirer, the acquirer's financial resources, and the intent in the acquisition.

Within 14 days of the acquisition, a draft of the letter of offer (that is, for the Open Offer, discussed below), will be submitted by the merchant banker to SEBI.

Open offer

The open offer or public offer refers to the exit opportunity given to the public to sell their shareholding in the Target Company. The acquirers are compulsorily required to make public offer to acquire a minimum 20% of the equity capital of the company.

The key issue in the open offer is the pricing of the open offer. The spirit of the Code is the equality and fairness of the opportunity granted to the shareholders – they public shareholders must get at least the best price offered by the acquirer when the acquirer made the substantial acquisition. Thus, the minimum price is the highest of

- The highest of the prices at which the negotiated acquisition might have been done
- The highest of the prices paid by the acquirer in a public issue, right issue or preferential issue within last 26 weeks.
- The higher of (a) the average of the weekly high and lows over the last 26 weeks, and (b) the average of the daily high and low prices over the last 2 weeks of the date of public announcement.

Exemptions under the Takeover Code:

- ✓ Allotment in pursuance of an application made to a public issue.
- ✓ Allotment pursuant to rights issue,
    - (i) to the extent of his entitlement; and
    - (ii) up to the percentage specified in Regulation 11

- ✓ Allotment to the underwriters pursuant to an underwriting agreement

- ✓ Inter- se transfer of shares amongst :-
  - (i) relatives within the meaning of Section 6 of the Companies Act, 1956
  - (ii) Qualifying Indian promoters and foreign collaborators who are shareholders;
  - (iii) Qualifying Promoters
- ✓ Acquisition of shares in the ordinary course of business by-
  - i. a registered stock-broker of a stock exchange on behalf of clients;
  - ii. a registered market maker of a stock exchange in respect of shares for which he is the market maker, during the course of market making;
  - iii. by Public Financial Institutions on their own account;
  - iv. by banks and public financial institutions as pledgees
- ✓ Acquisition of shares by way of transmission on succession or inheritance
- ✓ Acquisition of shares by government companies within the meaning of Section 617 of the Companies Act, 1956 and statutory corporations
- ✓ Pursuant to a scheme –
  - (i) framed under Section 18 of the Sick Industrial Companies (Special Provisions) Act,1985;
  - (ii) of arrangement or reconstruction including amalgamation or merger or demerger under any law or regulation, Indian or foreign
- ✓ acquisition of shares in companies whose shares are not listed on any stock exchange

Open Offer process in a nutshell