

# **Comments on SEBI's Draft Takeover Code**

**By**

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## **Abstract**

In this paper an attempt has been made to comment on the contents of the Draft Regulation for 'Substantial Acquisition of Shares in Listed Companies' of SEBI (Consultative Paper 1). The authors broadly concur with the guiding principles, thrust and coverage of the proposed regulation. They wonder whether the open market purchase as outlined in the proposal will fully protect the interests of the small shareholders. Accordingly, the paper argues as to why open market purchases should not be allowed and why all acquirers wishing to exceed the permissible holding must follow the procedure of open tender offers. Further, the paper brings out the need for a specific regulation governing the possibilities of partial and two-step takeovers. Reference is also made to relevant provisions of the UK and US codes in this regard. And finally, it is argued that with respect to takeover defences, the duties of an acquiree need to be spelt out explicitly, especially in certain specific areas.

# Comments on SEBI's Draft Takeover Code

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The Draft Regulation for 'Substantial Acquisition of Shares in Listed Companies' of SEBI (Consultative Paper 1) is indeed a timely and a useful document. It is important that the process of substantial acquisition of shares is not only fair but also equitable to all parties concerned in the process. The Draft Regulation, the broad contents of which are contained in Box 1, is an excellent effort in this direction, and provides much needed protection to minority shareholders in the event of acquisition bids. It outlines a transparent and orderly framework for substantial acquisition of shares of companies listed on the stock exchanges by any person - a corporate entity or otherwise, whether or not he is covered by the listing agreement. This removes a major lacuna in the current regulatory structure which relies on Clauses 40A and 40B of the listing agreement and is not therefore, applicable to acquirers who are not listed. The Regulation, when brought into force, will go a long way in curbing certain kinds of undesirable practices afflicting our capital market and will protect the interests of the small investors.

Box I about here

Experience in India and in the Western Countries reveals that there are several kinds of malpractices which arise in the context of takeovers and require regulatory counter measures. We have tried, in Box 2, to outline the most common and serious malpractices which we believe would well be worth bringing under the ambit of the regulations being envisaged. In the course of our analysis, we find that the Draft Regulations do cover many of these situations quite adequately. The focus of our comments are, therefore, on those areas in which we feel that the regulations need further strengthening to curb possible malpractices.

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Box 2 about here

### Open Tender Offer

In our opinion, the requirement that acquirers should make an open tender offer if he crosses a threshold shareholding by negotiated purchases is a very significant step forward. It will prevent the clandestine acquisition of shares at high prices from selected shareholders leaving the bulk of the shareholders high and dry. The open tender offer gives shareholders time to think and decide without being worried that the acquirer may not buy the shares of late comers. The malpractices listed in (1) and (2) of Box 2 are thus effectively curbed. Since these malpractices are the most important and serious ones as far as ordinary shareholders are concerned, we would go so far as to say that this by itself is sufficient to make the proposed regulations worthwhile.

### Open Market Purchase

We do, however, have some reservations about the system of open market operations that is permitted under the Draft Regulations. This system, it seems, is not completely consistent with guiding principles No. 4, 1, 2, 3 and 6 (Box 1). The reason is that, in our opinion, open market purchases allow the acquirer to force the shareholders to a hasty decision (see item 2 of Box 2). Consider for example a situation where the acquirer makes a public announcement that he intends to buy 35 % of the shares of the target company through the open market. The typical shareholder has no way of knowing how well the open market operations are succeeding. He is thus faced with a dilemma - should he hold on to his shares in the hope that the acquirer will be forced to offer a better price or should he sell immediately before the acquirer winds up his open market operations? In this situation, we believe that

- a) the small shareholders will be stampeded into tendering shares at low prices
- b) the small shareholders, particularly in rural and semi-urban areas will be severely disadvantaged in availing of the opportunity to sell.

In our opinion, therefore, the open market purchases should not be permitted and all acquirers who seek to cross the threshold shareholding must be asked to follow the open tender offers.

Partial Takeovers & Two Step Takeovers Another area in which we believe more stringent regulation is called for is in the area of two step takeovers (discussed under items (3) and (4) of Box 2). In one form of this takeover, the acquirer consolidates his

position in the first step by acquiring a significant proportion of control, and then makes the next move for a greater control. In the second form, what is also known as “boot strap” takeover, the takeover is made self financing by the acquirer by diverting the acquiree’s own funds to himself in form or other. Several different approaches have been evolved by regulators around the world to deal with this problem:

a) The UK takeover code frowns upon partial takeovers. Attempts to acquire less than majority control are permitted only under special conditions. Attempts to acquire majority but less than total control are allowed only if they are approved by the acquiree’s board and the holders of at least 50% of the voting rights not already owned by the acquirer.

b) Some US states permit partial takeovers but block the second step of the takeover. After the first step is completed, any subsequent merger, asset sale or other similar step requires approval of a majority of the remaining voting rights.

c) Some US states allow shareholders to tender any number of shares at the price at which the acquirer has bought shares in the partial takeover.

We believe that under Indian conditions, a total ban on partial takeovers may not be appropriate at this stage. Option (b) above is however more acceptable in the Indian context. We already have some similar provisions in Sections 293 and 314 of the Companies Act. These could be (a) strengthened to bring all second step takeover stratagems under their ambit. (b) modified to require a majority not merely of the entire voting rights but of the voting rights not already owned by the acquirer. If necessary, these stringent provisions could be limited to the first five years after the first step takeover is completed.

### Takeover Defences

We believe that the provisions in the Draft Regulations relating to the responsibility of the acquiree’s management need to be further strengthened particularly in the case of hostile takeovers. The major provision in this area in the Draft Regulations is 12 (v) of section 4.1. It is not clear whether this amounts to anything more than what is already required by Section 293 of the Companies Act. We believe that this clause should be enlarged to prohibit

a) assumption of any onerous obligations (often picturesquely described as poison pills or shark repellents).

b) fresh allotment of shares and convertibles to dilute the acquirer’s current holding.

The UK takeover code covers “any action ..... which could effectively result in any bona fide offer being frustrated or in the shareholders of the offeree company being denied an opportunity to decide on its merits” (general principle No. 4). The UK code further requires the Board of Directors to act in the best interests of the shareholders and not

have regard to their personal or family shareholdings or their personal relationships with the companies.

In addition to the above, we feel that there are certain other areas where obligations should be imposed on the acquiree management :

a) The “highest standards of accuracy” mandated in 4.1-12 (vi) should extend to statements issued by the acquiree management. Both for acquirer and acquiree, misstatements in these documents should attract the same civil and criminal liabilities which attach to the misstatements in the prospectus under the Companies Act.

b) There should be an obligation on the acquiree not to refuse transfer of shares where the shares have been acquired in accordance with the provisions of the Regulations. The acquiree should not be permitted to refuse the transfer on the ground that it would lead to a change in the composition of the Board of Directors (Section 22A(3)(c) of the Securities Contract (Regulation) Act). The very idea of a takeover bid is to effect a change in the Board, and once the shareholders have accepted an offer made in accordance with the Regulations, the Board should not be given any veto powers. Insider Trading

Guiding Principle No. 7 of the Draft Regulations deals with insider trading. The principal operative provisions of the Regulations on this matter are the ones that deal with disclosure of information. We would propose stricter control of insider trading in two respects.

a) A complete ban on insider trading in the period before the public announcement on the lines of rule 30 of the UK code which provides that:

“No dealings of any kind (including option business) in the shares of the offeree company by any person or company, not being the offeror, who is privy to the preliminary takeover or merger discussions or to an intention to make an offer may take place between the time when there is reason to suppose that an approach or an offer is contemplated and the announcement of the approach or offer or the termination of the discussions.

Similarly no such dealings shall take place, mutatis mutandis, in the shares of the offeror except where the proposed offer is not deemed price sensitive in relation to such shares”.

b) Where the takeover proposal is discussed with the acquiree’s Board, it is undesirable that the shareholders of the acquiree are kept in the dark for long. In such cases an announcement must be made to the shareholders as soon as there is agreement on the basic terms of the offer.

### Bail Out Takeovers

The special provisions relating to bail out takeovers should become operative only if effective control of the company rests in the creditors rather than in the equity holders. In

other words, where there is an actual or constructive default by the company and the creditors have forced or are in a position to force the company into winding up, the provisions of bail out takeover could be invoked. Mere wiping out of half of the peak net worth is neither a necessary nor a sufficient condition for this.

### Penalties

Criminal liability under the provision should be supplemented by civil liability for damages. There should also be a provision for denial of voting rights to shares acquired in violation of the regulations.

### Miscellaneous Issues

#### Listing Agreement

Currently, the principal regulatory instrument for dealing with takeovers is the listing agreement of the stock exchanges (Clauses 40A and 40B). Once the proposed Regulations come into force, these clauses of the listing agreement will cease to have any relevance. In any case, the ambit of these clauses is much narrower than that of the Regulations as they cover only listed companies. We would suggest that some of the sound provisions of Clauses 40A and 40B (particularly 40B(3), 40B(5), 40B(6) and 40B(11)) could be incorporated into the Regulations. The rest of the provisions of these clauses should stand superseded by the Regulations.

Also, following are our reactions to some of the detailed clauses (numbered on the left hand side below) of the Draft Regulation:

2.1 (ii) The requirement that the company on its own should notify SEBI within four days of any acquisition of more than 5% of its stock by a group of persons is, in our opinion, far too stringent. While it is reasonable to impose short reporting deadlines on the acquirer, it is unreasonable to place such onerous obligations on the company particularly in case of unfriendly takeovers. The company may take much more than four days to ascertain what is going on.

3.1 The import of the phrase “ but not exceeding 20% “ in the last paragraph of this section is not clear. Perhaps, what is intended is something on the lines of Clause 40B(6) of the listing agreement.

3.3 There are practical difficulties in extending the provisions of Section 3.3 to transactions between mutual funds. Trades of 1% of an investee company’s stock are quite common for normal portfolio adjustments. To require open tenders for these trades would unnecessarily increase transaction costs. The requirement of post facto public disclosure is, of course, quite welcome.

4.1-1 (i) This rule requires the offer to be in cash in certain cases. We think it would be sufficient to require that a cash alternative be provided.

4.1-1(ii)(a) We see little justification in compelling the offerer to pay more than the price that he has paid in negotiated purchase.

4.1-3 The public announcement should not be delayed by two days. The MOU should be followed **immediately** by a press release.

4.1-5(iv) Some restrictions are desirable on negotiated purchases made in circumstances where the ensuing public offer may be meaningless because the conditionalities are unlikely to be fulfilled.

4.1-12(viii) & 4.1.5(iv)(a) & 4.1.6

Where an offer is conditional on a minimum number of shares being acquired, more transparency and clarity is desirable about whether the condition has been met. This requires

(a) the offer must be kept open for say, 2 weeks after the minimum acquisition has been reached and a public announcement made to that effect.

(b) shareholders must not be permitted to withdraw offers after such announcement.

### **Conclusion**

We are in overall agreement with the guiding principles, thrust and coverage of the proposed regulation. However, we feel that the open market purchase as outlined in the proposal does not fully protect the interests of the small shareholders. Thus, in our opinion, open market purchases should not be allowed and all acquirers wishing to exceed the permissible holding asked to follow the open tender offers. Further, explicit regulation may be required to govern the possibilities of partial and two-step takeovers. The UK and US codes provide some guidance in this regard. And finally, with respect to takeover defences, the duties of an acquiree need to be spelt out explicitly. The main areas where some regulation may be required in this direction may be: assumption by the acquiree of any onerous obligation; fresh issue(s) of shares and convertibles aimed at diluting the acquiree's holding; standards of accuracy in the statements of the acquiree and obligations relating to transfer of shares.

## Box 1

### SUMMARY OF DRAFT REGULATION FOR

#### SUBSTANTIAL ACQUISITION OF SHARES IN LISTED COMPANIES

The Guiding Principles of the Regulation are defined to include (1) Equality of treatment and opportunity to all shareholders; (2) Transparency in acquisition of shares; (3) Fair and truthful disclosure through public announcement; (4) Availability of sufficient time for shareholders to make properly informed decision; (5) Avoidance of undesirable practices in substantial acquisition of shares and clandestine transactions; (6) Protection of rights for small and minority shareholders and, (7) Avoidance of use of price sensitive information concerning a public offer by all persons privy to confidential information for their own profits.

##### **(1) Disclosure**

If on the date of coming into effect of this Regulation, a person holds shares carrying more than 5% or more of the voting capital of a company, he shall disclose his aggregate shareholding to (a) SEBI and, (b) all stock exchanges on which the shares of the company are listed, within two months. Similar disclosure is required by any person who subsequently crosses the 5% threshold.

**(2) Negotiated Purchases** When a person who holds shares in a company has agreed to acquire further shares through negotiations, which taken together with shares already held, would carry more than 10% of the voting capital, he shall not acquire further shares, **unless he makes**, a public announcement of an offer to the remaining shareholders of the company.

##### **Procedures for Negotiated Purchases**

- (i) A public offer shall be made at a minimum offer price which means, the negotiated price or the average of the weekly high and low of the closing prices of the company whose shares are being acquired, whichever is higher.
- (ii) A public announcement for an offer to the remaining shareholders shall be made in at least one national English daily and one vernacular newspaper wherever the regional stock exchange of the company whose shares are being acquired is located.
- (iii) A public announcement of offer shall contain the terms of offer; identity of the ultimate acquirer; details of his existing holdings in the company
- (iv) The public offer shall open after not more than one month from the date of public announcement of offer and the offer shall be kept open for a period of 6 weeks thereafter.



### **(3) Purchases in the Open Market**

When a person who holds shares in a company has agreed to acquire further shares through negotiations, which taken together with shares already held, would carry more than 10% of the voting capital, **unless he makes**, a public announcement of his intention to acquire such additional shares through open market in a manner prescribed by SEBI.

#### **Procedures for Purchases in the Open Market**

- (i) A public announcement for an offer to the remaining shareholders shall be made in at least one national English daily and one vernacular newspaper wherever the regional stock exchange of the company whose shares are being acquired is located.
- (ii) A public announcement of offer shall contain the terms of offer; identity of the ultimate acquirer; details of his existing holdings in the company
- (iii) The period of purchases shall not in any case exceed 6 weeks from the date of announcement.
- (iv) Competitive acquisition by any other person may be made on the same company within 2 weeks from the date of first public announcement.

### **(4) Institutional Operations**

Public Financial Institutions shall not sell any shares exceeding 1% or more of the paid up capital of any company by negotiation to the same person, **unless**, they make a public announcement of the intention to sell the block of shares. Mutual funds shall also follow the same procedure in case of any negotiated sale. Public Financial Institutions selling in the open market shall make a public announcement of the sale.

### **(5) Bail Out Takeovers**

Revival of non-BIFR sick companies through bail out takeovers are exempted from some of the above provisions. The lead financial institution is vested with the task of evaluating various bids and is given the discretion to accept or reject them.

### **Penalties**

Violations of the provisions of this regulation shall be liable to fine and imprisonment or both and no prosecution can be filed by anyone other than an officer of SEBI.

## **Box 2**

### **Undesirable Practices**

We outline below some of the more important and serious undesirable practices that have been observed in the context of takeover bids in India and abroad. In our opinion, regulatory action to curb these practices would be well worth the effort.

1. The Acquirer buys substantial number of shares through clandestine transactions at high prices. The majority of shareholders do not realize what is going on and do not get an opportunity to dispose off their holdings at the same favourable terms. This is addressed in guiding principles 1, 2, 3 and 6 of the Draft Regulations.
2. The acquirer forces the shareholders to a hasty decision through the veiled threat that if they dither for long, the acquirer may, no longer, be ready to buy the shares. This threat is credible because once the acquirer has obtained a controlling shareholding, he need buy no more. This is addressed by guiding principles 4 and 6 of the Draft Regulations.
3. The acquirer resorts to a two step takeover. In the first step he acquires sufficient shares at premium rates to achieve partial control. From this position of strength, he then proceeds to squeeze out the remaining shareholders through gradual purchases, preferential allotment and other means. The second step becomes a relatively cheap operation for the acquirer.
4. Closely related to the above, is the attempt to make the takeover self financing, in what is often called a `bootstrap' takeover. In the second step of the takeover operation, the acquirer diverts the acquiree's own funds to himself by merger by open or surreptitious credit and by fraudulent transfer pricing methods. To facilitate this operation, the acquirer may force the acquiree to sell part of its assets or tap its unutilized borrowing capacity.
5. The acquiree company's management faced with a hostile takeover seeks to frustrate it by :
  - a) refusing share transfer
  - b) painting rosy picture of the company's future to suggest that the price offered by the acquirer is inadequate.
  - c) selling the company's assets, acquiring onerous obligations or many other stratagems to make the company less attractive to the acquirer.
  - d) issuing further shares or instruments convertible into shares so as to reduce the acquirer's current shareholding percentage.

e) where there are competing offers, attempt to favour its preferred suitor even if its bid is less advantageous to the shareholders.

6. Insider trading by the acquirer, the acquiree's management and their advisors/associates.