

**Discussion Paper on “Brightline Tests for Acquisition of ‘Control’
under SEBI Takeover Regulations”**

Objective

1. This discussion paper seeks comments of the public for certain proposals related to Brightline Tests for Acquisition of ‘Control’ under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (hereinafter referred to as the "Takeover Regulations”).

Background

2. The Takeover Regulations prescribe that an acquirer acquiring substantial shares or voting rights i.e., 25% or more, has to make an open offer to the public shareholders of the target company. Irrespective of the shares or voting rights acquired, the acquirer also has to make an open offer upon acquiring control of the target company.

3. Definition of 'Control'

Regulation 2(1)(e) of Takeover Regulations, 2011 has defined 'control' as
Regulation 2(1)(e): “control” includes the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner:

Provided that a director or officer of a target company shall not be considered to be in control over such target company, merely by virtue of holding such position.

4. From the definition of control as defined under the Takeover Regulations, 2011, it is observed that regulation 2(1)(e) defines "control" as inclusive of
 - The right to appoint a majority of directors
 - The right to control the management
 - The right to control the policy decision
5. Such rights can be exercisable by one person or by more than one person who are persons acting in concert. Further, such rights can be exercisable directly or indirectly. The right can accrue to a person in any of the following manner:
 - Shareholding
 - Management rights
 - Shareholders agreements

- Voting agreements
- In any other manner

Historical Perspective

6. It may be mentioned that the Bhagwati Committee which was constituted to review the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1994, recommended a broad definition of control and opined that it should be left to SEBI to decide whether there has been an acquisition of control on the basis of facts of each case. The Takeover Regulations Advisory Committee (TRAC), in its report dated July 19, 2010 also reiterated the above views of the Bhagwati Committee.

Need for Bright Lines on Control

7. The term "control" which is defined in regulation 2(1)(e) of Takeover Regulations, 2011 provides for the broad contours which would constitute control and at the same time it has left the scope open to include factors to be covered within the ambit of the definition.
8. Assessing whether an entity controls a company is straightforward in cases where the rights accrue to the entity through its shareholding/voting rights in the company. In cases of rights accruing through contractual agreements, such assessment becomes complex and requires consideration of facts and circumstances of the case. Therefore, the nature of definition of control is based on certain defined principles rather than rule-based. It is only while applying these principles on a set of facts, that there is a rise of multitude of opinions and has led to litigations.
9. It has been represented by market participants to SEBI to provide a list of protective rights which would not amount to acquisition of control. However, other such participants were of the view that it may not be possible to prepare an exhaustive list of such rights which would address all situations.
10. Further, control is also defined under other laws in India. Certain Acts such as Companies Act, 2013, Insurance Laws (Amendment) Act, 2015 and FDI Policy and have a similar definition of control as under Takeover Regulations. The Companies Act, 2013 defines "control" as:
- "control" shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner."*

11. The Insurance Laws (Amendment) Act, 2015 defines “control” as:

“control” shall include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements.”

12. Similarly, Consolidated FDI Policy Circular of 2015 defines “control” as:

“control” shall include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements.”

13. Also, with the advent of Competition Act in 2002, it is seen that control has been tested by the Competition Commission of India from its own perspective. The definition of 'control' under the Competition Act, 2002 is provided by way of an Explanation to section 5 of the said Act as under-

“Explanation — For the purposes of this section,—

(a) “control” includes controlling the affairs or management by—

(i) one or more enterprises, either jointly or singly, over another enterprise or group;

(ii) one or more groups, either jointly or singly, over another group or enterprise;”

14. It is seen that the above definition of 'control' in the Competition Act, 2002 is a purposive definition and applies for the specific purpose of combination of enterprises by way of *inter alia*, acquisition of one or more enterprises or 'control' over an enterprise by one or more persons. From the language of Explanation to section 5 of the Competition Act, 2002, and regulation 2(1)(e) of the Takeover Regulations, it is noted that both contain inclusive definition. It is, however, noted that while the definition under 2(1)(e) is specific with regard to control by way of (a) right *“to appoint majority of the directors”* or (b) *controlling ‘the management or policy decisions’*, the definition under section 5 is only specific with regard to *“controlling the affairs and management”*. It is further noted that while under the Takeover Regulations controlling the *“management or policy decisions”* is relevant factor, under the Explanation to section 5 of the Competition Act controlling *“the affairs and management”* is relevant factor. The expression *“affairs and management”* may be of much wider connotation than the expression *“management or policy decisions”*. There could be a situation wherein by controlling *“the affairs and management”* in a company, a person may be in a position to control *“management or policy decisions”* but it may not always be the case.

15. Similarly, sectoral regulators such as Civil Aviation may also apply the test of control to determine whether the control over the target company remains with an Indian national. International Financial Reporting Standard (IFRS) also defines the principle of control and establishes control as the basis of determining which entities are consolidated in the consolidated financial statements. Under IFRS, the principle of control sets out the following three elements of control:

(a) *power over the investee;*

(b) *exposure, or rights, to variable returns from involvement with the investee; and*

(c) *the ability to use power over the investee to affect the amount of the investor's returns.*

16. One regulatory agency may be guided by the findings of other regulatory agency on a particular issue only if the two laws are *pari materia* in their substance and are being applied on the same set of facts and circumstances.

17. In view of the above, it is possible that in a given scenario multiple regulators may all be applying the test of control from different perspectives and arriving at differing results which may lead to ambiguity and confusion in the market.

International Scenario

18. Regarding the aspect of control, it is observed that in countries such as Australia, Germany, New Zealand, Russia, Hong Kong, Singapore, South Africa and UK, the change of control is considered to be the same as acquisition of voting rights above the specified thresholds irrespective of whether such holdings confer *de facto* control.

19. Further, in countries such as Japan, Malaysia, Switzerland and USA, control has not been defined for the purpose of takeovers.

20. Further, in countries such as Canada, France, Ghana, Norway and Spain, an entity is deemed to be in control of a company, if it has the right or exercises control, directly or indirectly, over the majority of voting rights at the general meetings of the company or has the ability to control the composition of a majority of the board members of the company.

21. Countries such as Brazil, China, Denmark, Indonesia, Italy and Nigeria have a similar definition to India's, wherein, control is deemed to be exercised not only through voting rights and appointment of board members, but also through the ability

to exercise influence over the company's policies or its shareholder meetings, even if the entity holds voting rights below the specified thresholds.

22. From the above, it is seen that in most of the countries, control has been defined in terms of the specified voting rights irrespective of *de facto* control. Some of the countries have also included the ability to control the composition of board members and further, ability to exercise influence over the company's policies/shareholder meetings.

23. In view of the above, it is seen that there is a need to identify bright lines for control. The following options may be considered:-

Option 1:- Framework for Protective Rights

24. In the matter of *Subhkam Ventures (I) Pvt. Ltd.* wherein SEBI had taken a view that the rights conferred upon the acquirer, through the agreements, amounted to 'control' over the target company. Hon'ble SAT, in its judgment dated January 15, 2010, rejected SEBI's view stating that none of the clauses of the agreements, individually or collectively, demonstrated control in the hands of the acquirer. Hon'ble SAT had observed that:

"...Control, according to the definition, is a proactive and not a reactive power. It is a power by which an acquirer can command the target company to do what he wants it to do. Control really means creating or controlling a situation by taking the initiative. Power by which an acquirer can only prevent a company from doing what the latter wants to do is by itself not control. In that event, the acquirer is only reacting rather than taking the initiative. It is a positive power and not a negative power....The test really is whether the acquirer is in the driving seat....By no stretch of logic, can such an affirmative vote confer control over the day to day working of the company...Affirmative vote of the investor in these matters is necessary for protecting its investment....Such fetters fall far short of the existence of "control" over the target company. It must be remembered that every fetter of any nature in the hands of any person over a listed company cannot result in "control" of that person over that company..."

25. However, Hon'ble Supreme Court, in its judgment dated November 16, 2011, stated that *'keeping in view the above changed circumstances, it is in the interest of justice to dispose of the present appeal by keeping the question of law open and it is also clarified that the impugned order passed by the SAT will not be treated as a precedent.'*

Principle

26. The basic principle that can be followed is that veto rights not amounting to acquisition of control may be protective in nature rather than participative in nature i.e. such rights may be aimed with the purpose of allowing the investor to protect his investment or prevent dilution of his shareholding. At the same time, the Investor should neither have the power to exercise control over the day-to-day running of the business nor the policy making process. Having rights in decisions involving a significant change in the current business activity or that apply on exceptional circumstances would also be treated as a protective right.

27. In terms of the aforesaid principles, an illustrative list of rights have been categorized below as protective in nature. These rights would be provided as a guidance to the market within the existing definition of control:-

Protective Rights - Rights which do not amount to exercise of "control", neither individually nor collectively, with any other right listed below:-

- a) Appointment of Chairman/ Vice Chairman - The Chairman/ Vice Chairman may be a nominee of the Investor provided he does not hold any executive position and does not have any casting vote and is counted as a representative of the Investor.
- b) Appointment of Observer - The investor may appoint his nominee as the observer of the Board who does not have any voting or participation rights.
- c) Covenants specified by Lenders provided these rights are customary to the lending business and the lender has granted the loan strictly on commercial basis. Further, such lender should be in the business of lending such as banks, NBFCs, etc.
- d) Commercial Agreements - The rights conferred on parties to a Commercial Agreement would not amount to control provided that
 - i) The mutual commercial benefit should flow from both the sides i.e. the commercial agreement should not be one-sided.
 - ii) The Board of the Target Company has approved the decision to enter into such an agreement.
 - iii) The Board of the Target Company / Target Company, should have the right to terminate the agreement.
 - iv) The Board of the Target Company / Target Company should have the right to enter into similar arrangement with any other party.
- e) Veto/Affirmative Rights - Veto rights in matters that are not part of the ordinary course of business or involve governance issues would be considered as protective in nature and would not amount to exercise of control over the target company:-

- i) amendments to memorandum and articles of association of the target company which adversely impact the investor's rights;
 - ii) any alteration to the capital structure of the company. These may include issue of capital or convertible securities, buyback, reduction of capital, merger, demerger, arrangement or compromise with its creditors or shareholders or effecting any scheme of amalgamation or reconstruction, etc.
 - iii) effecting any change in the statutory auditors of the company;
 - iv) material divestment, transfer or disposal of an undertaking or material subsidiary of the target company.
 - v) related party transactions other than those entered into in the ordinary course of business and which are on arms' length basis.
 - vi) material acquisition of any companies, bodies corporate, business, undertaking or joint ventures.
 - vii) assuming or incurring any indebtedness or providing any loans or issuing any guarantees or creating any security in excess of the thresholds permissible without special shareholder approval under the Companies Act, 2013.
 - viii) winding up of the company or making a general assignment for the benefit of the creditors of the company and/or the subsidiaries or admitting in writing the inability of the company to repay its debts when they become due.
 - ix) write-off of any of the receivables, loans and advances, investment or investments or inventories outside the ordinary course of business;
- f) Quorum rights for meetings involving the matters listed above. If two meetings are not quorate, the next meeting would be deemed to have quorum despite the absence of the investor nominees.

28. The grant of the above rights may be subject to the following conditions:-

- a) The investor bestowed with the rights mentioned above, must invest at least 10% or more in the target company.
- b) Every company should formulate a policy defining the parameters that will be "material" or "outside the ordinary course of business" for clauses 24(e)(i), 24(e)(iv), 24(e)(v), 24(e)(vi) and 24(e)(ix) which shall be disclosed to the shareholders. Grant of the protective rights mentioned under para 24 above, to an investor shall be subject to obtaining the public shareholder's approval (majority of minority) in this regard. Such rights shall also be incorporated in Articles of Association of the company after obtaining shareholders' approval.
- c) In case of IPOs, the existing agreements would need to be cancelled/modified or suspended till the approval of public shareholders (majority of minority) is taken post-listing of shares.

Option 2:- Adopting a numerical threshold

29. Considering the international practices and the current regulatory environment in India, the definition of control may be amended such that control is defined on the basis of the right or entitlement to exercise certain specified voting rights of a company, or the right to appoint certain number of directors of a company.
30. In India, the Companies Act recognizes any holding in excess of 25% as the threshold at which special resolutions can be blocked. Further, the threshold for substantial acquisition under the Takeover Regulations is 25%. It would, thus, be appropriate that 25% may also be specified as the threshold level for trigger of control in Indian listed companies.
31. Further, with respect to the control being exercised through the right to appoint majority of directors, it may be mentioned that Regulation 17 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 mandates that at least one-third of the board of directors shall comprise of independent directors where the chairperson of the board of directors is a non-executive director, and at least half of the board of directors shall comprise of independent directors where the listed entity does not have a regular non-executive chairperson.
32. Thus, there would a large number of listed companies in which at least half of the board members are independent and thereby, right to appoint majority of directors would not be applicable to such cases. Therefore, an entity having the right to appoint majority of non-independent directors may be considered to be in control of the company.
33. In view of the above, the definition of 'control' under the Takeover Regulations may be amended such that control is defined as:
*“(a) the right or entitlement to exercise at least 25% of voting rights of a company irrespective of whether such holdings gives de facto control
and/or
(b) the right to appoint majority of the non-independent directors of a company.”*

Pros and Cons of the above two options:-

34. Investor having the protective rights as mentioned under Option 1 would continue to be a public shareholder and acquisition of the said rights would not amount to acquisition of 'control' under the Takeover Regulations, 2011. However, this only being an indicative list, acquisition of other rights would be examined on the basis of the facts and circumstances of the case. In case such rights are deemed to be

participative in nature, it would amount to acquisition of 'control' and necessitate an open offer under regulation 4 of the Takeover Regulations, 2011. However, this approach may lead to further complexities in assessment of control and lead to ambiguity in interpretation.

35. In case Option 2 is adopted, the acquisition of control through other means such as special rights, etc. would not necessitate an open offer requirement under the Takeover Regulations. However, it would reduce the uncertainty in the assessment of acquisition of 'control' and bring clarity. Further, the extent of influence by the investor over the board of directors would also be ascertainable in all cases.

Public Comments

36. Considering the implications of the said matter on the market participants, public comments are solicited on the following:-

- (a) "Whether option 1 or option 2 or any other option is preferable in the Indian context."
(b) Any other suggestions/comments.

Specific comments/suggestions as per the format given below would be highly appreciated:

Name of entity/person/intermediary:		
Name of organization (if applicable):		
Sr. No.	Proposed/suggested changes	Rationale

37. Such comments may please be e-mailed on or before April 14, 2016, to **control@sebi.gov.in** or sent by post, to:-

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