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Article

SEBI's Bright Line Tests for 'Control' - An Analysis

By **Prarthna Baranwal**

Background

The idea of corporate control has been subject to a longstanding debate in India and elsewhere. A fluid concept such as 'control' is a term of wide connotation and, by its very nature, is not amenable to any precise standard definition of general application. What constitutes control is most often a subjective test and is best determined on case to case basis. The crucial obligation under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (hereinafter referred to as the 'Takeover Regulations') is the requirement to make an 'open offer' to the public shareholders of the target company upon a substantial acquisition of shares or voting rights or *acquisition of control* of the target company, directly or indirectly. Thus, the quest for the appropriate definition of 'control' for Takeover Regulations is driven by the underlying rationale of providing the minority shareholder an exit opportunity.

In India, over time, the definition of 'control' has been subject to different assessments and has turned to be, quite manifestly, a grey area under the Takeover Regulations. The Supreme Court in case of *SEBI* v. *Subhkam Ventures Private Limited*[1] had left the question of control unattended and undecided. SEBI has finally decided to address this issue and has recently issued a Discussion Paper[2] seeking public opinion over certain proposals related to bright line tests for defining control for the purpose of the Takeover Regulations.

According to SEBI, there is a need for a bright line test for control as the existing definition of control in the Takeover Regulations[3] has broad contours resulting in multitude of opinions and a number of litigations. Further, the Discussion Paper refers to the definition of control provided in several other statutes/regulations[4] and emphasizes that, in the present scenario, there are multiple sectoral regulators like the Department of Industrial Policy and Promotion

[1] MANU/SC/1587/2011, the Supreme Court had, in a one page order, accepted the out of court settlement between the parties and specifically stated that the question of law i.e. whether negative control is control, remained open and the earlier decision by SAT (holding that negative control would not amount to control) would not to be treated as a precedent.

[2] Discussion Paper on "Brightline Tests for Acquisitions of 'Control' under SEBI Takeover Regulations" , available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1457945258522.pdf

[3] Regulation 2(e)of the Takeover Regulations: *"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] See the Competition Act, 2002, Insurance Laws (Amendment) Act, 2015, Companies Act, 2013, FDI Policy Circular, 2015 etc.

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(DIPP), Insurance Regulatory and Development Authority of India (IRDAI), Civil Aviation Regulators and Competition Commission of India (CCI). In the light of several definitions available under different statutes/regulations and the presence of several regulators, there could be a situation where a regulator may or may not rely on the interpretation given by other regulator to ascertain control. This may result in confusion in the market as different regulators may adopt different perspectives. The Discussion Paper also examines the definition of 'control' as applicable in several other jurisdictions such as Hong Kong, Germany and Singapore, Canada and USA and highlights that quite a few jurisdictions have adopted objective tests to ascertain control.

Therefore, SEBI has proposed the following two options:

Option 1- Framework for Protective Rights

SEBI has listed down several illustrative situations where negative control or, affirmative voting rights or protective clauses in the shareholders' agreement shall not be regarded as 'control'. The proposal is actually illustrative in nature and seeks to protect strategic and financial investors who may seek protective rights in targets through shareholders' agreements and corporate constitutional documents.

Under this option, the Discussion Paper has laid down the following instances which will not amount to acquisition of control in any manner:

(i) *Appointment of chairman/vice chairman:* A chairman or vice chairman may be a nominee of an investor, provided the person does not hold any executive position and does not have a casting vote.

(ii) *Appointment of observer:* An observer appointed by an investor without having any voting or participation rights.

(iii) *Customary lender covenants:* Banks/ non-banking finance companies (NBFCs) may have customary covenants specified by lenders provided the lender has granted the loan strictly on commercial basis.

(iv) *Commercial Agreements:* Rights conferred on the parties to a commercial agreement would not amount to control, provided it is for mutual commercial benefit and the board of the target company shall have approved, has the right to terminate and have the right to enter into similar arrangement with any other party.

(v) *Veto/Affirmative Rights:* SEBI has provided an illustrative list of veto/ affirmative rights in matters that are not part of the ordinary course of business or involve governance issues, which include, *inter alia,* amendments to memorandum and articles of association of the target company which adversely impact the investor's rights, any alteration to the capital structure of the company and material divestment. Such

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affirmative rights shall be considered as protective in nature and would not amount to exercise of control over the target company.

(vi) *Quorum rights:* For meetings involving the illustrative list of veto/ affirmative rights, if two meetings are not quorate, the next meeting would be deemed to have quorum despite the absence of the investor nominees.

The above-mentioned protective rights shall be subject to several conditions, such as:

(a) *Minimum 10% investment:* The respective investors must invest at least 10% in the target company;

(b) *Public shareholders approval:* The grant of such rights will be mandated to require public shareholders' approval;

(c) *Incorporation in articles of association:* The aforesaid protective rights shall also be incorporated in articles of association of the company;

(d) *Initial Public Offer (IPO):* In case of an IPO, the existing agreement needs to be modified or cancelled until the approval of public shareholder (majority of minority) is taken after the listing.

Also, it has been suggested that every company should formulate a policy to ascertain which transactions are '*material*' for the purpose of affirmative votes on '*material divestment*' and '*material acquisition*'. Further, the Discussion Paper has recommended that a policy should be formulated to define *'outside the ordinary course of business'* for the purpose of the illustrative list of rights.

This option does attempt to restrict the definition of control, however, the element of subjectivity cannot be ruled out. This is because SEBI can only prescribe an indicative list of affirmative votes that will be protective rather than participative in nature. In this regard, it is noteworthy that SEBI has included appointment of observer in the illustrative list, however, it has failed to clarify the status regarding appointment of one or more directors. It is impossible to provide an exhaustive list that will encompass every single voting matter due to the fact that new rights may be drafted and negotiated in different ways which could be read subjectively and falling outside the scope of protective rights.

Also, it is quite likely that the list of protective rights that SEBI proposes to lay down, though illustrative, might be read literally by the regulators as well as practitioners. By applying the interpretation rule of *expressio unius est exclusio alterius* (i.e. to express one thing is to exclude another), the regulators/practitioners may tend to think that all that is not covered by the illustrative list may be construed as 'control'. Further, the conditions imposed on these protective rights need some clarification, for example, it is not clear if the condition pertaining to minimum 10% investment in the target company is applicable to secondary

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acquisition. Also, by introducing the condition regarding incorporation of protective rights in the articles of association, the proposal has tried to introduce the aggressive principle of many years that was sought to be corrected by the Companies Act, 2013.

Therefore, this option may result in more cases ending up before the regulator and may not deliver the intended results, with investments still getting stalled in disputes as to whether control has been acquired or not.

Option 2- Numerical Threshold

The Discussion Paper recommends, as one of the other options, to amend the definition in the Takeover Regulations as follows:

> *"(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"*

It is pertinent to note here that SEBI has included the right to appoint the majority of *'non-independent'* directors in the above definition as by virtue of the requirements prescribed under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015,[5] appointing the majority of the directors may be a highly remote possibility.

By adoption of the proposed definition of control under 'Option 2', a number of scenarios could potentially emerge. The proposed amended definition would create a statutory presumption of control on holding of 25% voting rights and it is not prudent to lose the sight of the fact that there may be repercussion on several other laws which may tag themselves with the definition of control as provided in the Takeover Regulations such as the Companies Act, 2013, the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Application of the numerical threshold, decoupled with *de facto* control, may also induce an element of arbitrariness. One can visualize a situation where to escape the mandatory open offer, an acquirer may acquire up to 24.9% of the target company. In such circumstances, the acquirer's ability to exercise *de facto* control over the target company would depend, among other things, on the shareholding pattern of the target company. If there is no other shareholder with similar voting rights, then the acquirer may be able to effectively exercise control over the target company and influence its management and policy decisions without making a mandatory offer.

The rationale behind introducing the threshold of 25% of the voting rights is also based on the fact that as per the Companies

[5] Refer Regulation 17 of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, according to which, a listed company is required to compose its board of at least one-third of the directors on the board being independent directors if the chairman is a non-executive director and must have half of the directors on the board being independent directors if the chairman is an executive director.

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Act, a special resolution requires a three fourth majority and an investor holding more than 25% of the voting rights shall be in a position to block special resolutions. However, it is noteworthy that sometimes an investor requires more than 25% voting rights merely to be able to block special resolutions, and the effective control, even in that situation, may lie with the other shareholders holding the remaining voting rights depending on how thinly those voting rights are split amongst other shareholders as there are several decisions such as appointment or removal of directors which require only a simple majority vote. Therefore, introduction of 25% threshold may result in the regulatory treatment of an investment transaction contrary to the commercial intention of the parties.

Conclusion

As elucidated above, it is evident that each of the options suffer from certain deficiencies both conceptually and operationally. However, certainly, from an investor's perspective, the present Indian scenario is riddled with uncertainties that may have chilling effect over investments in listed targets. Therefore, SEBI's proposal to adopt a bright line test to ascertain control for the purpose of Takeover Regulations is, undoubtedly, a substantial step towards improving the ease of doing business in India.

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Notifications & Circulars

Nomination of director - Acceptance of deposits by Indian companies: The Reserve Bank of India has clarified that keeping deposits with an Indian company by persons resident outside India in accordance with Section 160 of the Companies Act, 2013 is a current account (payment) transaction and, as such, does not require any approval from Reserve Bank. RBI A.P. (DIR Series) Circular No. 59, dated April 13, 2016 issued in this regard notes that while Foreign Exchange Management (Deposit) Regulations, 2016, announced on 1-4-2016, provide that no person resident in India shall accept any deposit from, or make any deposit with, a person resident outside India, Section 160 of the Companies Act, 2013 requires a person who intends to nominate himself or any other person as a director in an Indian company to place a deposit with the said company. It is stated that all refunds of such deposits, arising in the event of selection of the person as director or getting more than twenty five percent votes, have to be treated similarly.

Remittance outside India of assets held in India: The Reserve Bank of India, in supersession of the Foreign Exchange Management (Remittance of Assets) Regulations, 2000 has issued new Foreign Exchange Management (Remittance of Assets) Regulations, 2016 in respect of remittance outside India by a person whether resident in India or not, of assets in India. The said regulations *inter alia* has fixed the annual

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ceiling of remittance at USD 1,000,000 (US Dollar One million only), beyond which permission would be required from RBI. Further, the said regulations have also made provisions of remittance in case of closure or winding up of a branch or office established in India by a person resident outside India. The RBI has issued Notification No. FEMA 13 (R)/2016-RB in this regard.

Exemption from filing financial statements in XBRL format: The Ministry of Corporate Affairs has issued the Companies (Filing of Documents and Forms in Extensible Business Reporting Language) Amendment Rules, 2016 to amend Rule 3 of the basic Rules of 2015, which prescribes the class of companies required to file financial statements and other documents under Section 137 of the Companies Act, 2013 to the registrar in e-form AOC-4 XBRL. The amendment in this regard inserts a proviso to Rule 3 exempting companies in banking, insurance, power sector, non-banking financial companies and housing finance companies from filing financial statements under the rule.

SEBI gives roadmap for disclosure of financial information in offer documents in accordance with Ind AS: In order to align disclosure requirements for financial information in the offer document as specified under SEBI (ICDR) Regulations, 2009 with the requirements of Ind AS, Securities and Exchange Board of India (SEBI) has specified the roadmap according to which the Indian Accounting Standards have to be followed. According to Circular SEBI/HO/CFD/DIL/CIR/P/2016/47, dated 31-3-2016 issued in this regard, the same is applicable for all companies required to disclose financial information in accordance with Ind AS as per MCA roadmap and whose offer document is filed with the Board on or after April 1, 2016.

Ratio Decidendi

Stamp duty on inter-state amalgamations – Court Order represents 'instrument': The full bench of the Bombay High Court has held that two orders of two different High Courts pertaining to the same scheme of amalgamation are independently different instruments, since the said orders of the High Courts are upon two different petitions by two different companies. In this regard, the Court has observed that the scheme of the legislation is based on chargeability on instrument and not on transactions. The Court hence found it immaterial to examine whether the document pertained to one and the same transaction. It was held that what is relevant for purposes of payment of stamp duty is the court order, which represents the 'instrument', and not the scheme.

The Court also considered the question whether the orders of the court by virtue of being related to a common scheme of amalgamation are incidental in nature and whether it is sufficient to stamp the '*principal instrument*', being the order of the Gujarat High Court. The said argument was not accepted by the Court on account of the fact that Section 4 of the

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Bombay Stamp Act which deals with incidental instruments is specific only to some types of agreements such as development agreement, sale, mortgage or settlement.

Another question that came up for discussion was whether in terms of Section 19 of the Bombay Stamp Act, 1958 wherein a document executed outside a State is subsequently brought into the State, stamp duty would have to be paid on that instrument after giving appropriate credit to duty that has already been paid in another state. Since the Court had already concluded that an amalgamation comprises two court orders, it was held that what was relevant for purposes of considering the stamp duty liability in Maharashtra was the order of the Bombay High Court. The Court in this regard held that since the order of court was signed in Maharashtra, it was 'executed' within the State, due to which the provisions of Section 19 would not apply. [*Chief Controlling Authority* v. *Reliance Industries Limited* - W.P No.1293 of 2007 in Reference Application No. 8 of 2005, Bombay High Court]

Being a Director does not amount to holding a place of profit or being in employment:

Delhi High Court has held that being a director, in a non-remunerative and non-executive position in other companies (group companies in the dispute) does not amount to being in employment of those companies or holding a place of profit in those companies. Denial of approval for appointment of a relative of the director of the company as Executive President, for a specific annual remuneration, was hence found to be erroneous by the Court. The Ministry of Corporate Affairs had earlier denied the approval observing that in terms of Rule 5 of the Directors' Relatives (Office or Place of Profit) Rules, 2011, the appointee should be in the exclusive employment of the Company and not hold a place of profit in any other company. The Court however found the principle as stated by the MCA as being without any merit inasmuch as the same did not have any basis in the Rules or any other provision in the Companies Act, 1956. It was observed that from the factum simplicitor of serving at Board level in other companies, the appointee cannot be held to be in the employment of those companies. [*Jagran Prakashan Ltd.* v. *Union of India* - W.P (C) No.10553 of 2015, Delhi High Court]

Principles of natural justice to be observed by CCI while disagreeing with DG report:

Observing that Competition Commission of India (CCI) had, at no stage of the proceedings, after the receipt of investigation report, given any notice to the appellants indicating/ incorporating the reasons for its disagreement with the findings/conclusions recorded by the Jt. DG that the appellants had not formed any cartel or acted in contravention of Section 3(1) and Section 3(3)(a) of the Act, the COMPAT has set aside the Order of the CCI. Violation of principles of natural justice was noticed by the Tribunal in this regard while it observed that no opportunity was given to the appellant to show that the reasons recorded by the Commission for its disagreement with the findings and conclusion recorded by the Jt.

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DG were untenable and also to show that they (appellant) had not formed any cartel.

It was held that the Commission was duty bound to comply with the mandate of Section 36(1) of the Competition Act and that by not doing so, the appellants was deprived of a valuable opportunity to effectively defend themselves against the proposed action of imposition of penalty. The CCI in its impugned order has disagreed with the findings of the DG and held that the appellants had acted in a concerted manner in fixing and revising the FSC rates and thereby contravened the provisions of Section 3(1) and Section 3(3)(a) of the Competition Act. [*Interglobe Aviation Ltd*. v. *Secretary, Competition Commission of India* – Appeal Nos. 7, 8 and 11/2016, decided on 18-4-2016, COMPAT]

Penalty for violation of SEBI provisions – Absence of definitive stand of SEBI: Observing that Securities and Exchange Board of India (SEBI) was not in a position to take a definite stand on the question as to whether violation of Section 12A(b)&(c) of the SEBI Act and violation of Regulation 3(c)&(d) of SEBI (Prevention of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 constitute one offence or two offences, the Securities Appellate Tribunal has set aside the Order of the SEBI. The Tribunal in this regard observed that AO's impugned Order considering violation under above mentioned provisions as independent and thus imposition of separate penalties, was in conflict with other Orders of the SEBI, wherein common penalty was imposed under Section 15HA of SEBI Act. It was also held that by defending the conflicting orders passed by the AOs, SEBI was neither promoting the development of the securities market nor was acting in the interests of the securities market. [*Krishna Enterprises* v. *SEBI* - Misc. Application Nos. 84 and 85/2015 in Appeal No.131 and 132/2015, decided on 20-4-2016, SAT]

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