UPDATES

SEBI's proposal on fixed-price delisting: A boost to public M&A

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This update covers:

1 Overview

Take-private transactions pose unique challenges for regulators, given that they involve strong competing policy objectives – incentivising efficient allocation of capital and value-accretive public M&A on the one hand, and ensuring protection of interests of public shareholders in an asymmetric informational environment, on the other. The Indian securities regulator – the Securities and Exchange Board of India (**SEBI**) – has also grappled with this conflict and currently mandates a unique *'reverse book building'* (**RBB**) method of price discovery, with the objective of securing a fair exit price for public shareholders. There is general market consensus that the RBB mechanism has made the delisting process complex, costly, uncertain and prone to manipulation.

In a move to rationalise the rules relating to take-private transactions, SEBI has proposed a new method for delisting at a fixed offer price, as an alternative to the existing reverse book building method. This change would bring the rules in India closer to more mature markets and is expected to boost public company M&A/PIPEs.

In a welcome move, SEBI has proposed a new method for delisting at a *'fixed price'* through its consultation paper of 14 August 2023 (**Consultation Paper**). The existing rules and the key highlights of the proposed changes are discussed below.

2 Existing reverse book building method

Under the existing SEBI (Delisting of Equity Shares) Regulations, 2021 (**Delisting Regulations**), an acquiror/promoter[1], who proposes to delist the shares of a listed company (**Listco**) from the stock exchanges, is required to provide an exit opportunity to public shareholders of the Listco (through a delisting offer). Under the delisting offer, the acquiror offers to buy-out the public shareholders in the Listco at a price to be determined under the Delisting Regulations.

2.1 Floor price

The offer price for delisting is subject to a *'floor'* (**Floor Price**), which is computed in the same manner as the floor price for an open offer under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (**Takeover Code**). For *'frequently traded'*[2] shares, the Floor Price is the highest of the following:

a. the negotiated price in the underlying acquisition, which triggered the open offer;

b. the volume-weighted average price paid by the acquiror or a person acting in concert (**PAC**) to acquire shares of the Listco during the 52 weeks preceding the reference date;

c. the highest price paid by the acquiror or a PAC to acquire shares of the Listco during the 26 weeks preceding the reference date; and

d. the volume-weighted average trading price of the shares for the 60 trading days preceding the reference date.

The reference date for this purpose is the date on which stock exchanges are notified of the board meeting at which the Listco approved the delisting offer.

For shares which are not frequently traded, the Floor Price is the highest of the price determined under (a), (b) and (c) above and the fair value of the shares as determined by an independent valuer, taking into account customary valuation parameters.

2.2 Reverse book building

The Floor Price is declared upfront by the acquiror. The delisting price is then discovered through a book building process – this involves public shareholders bidding (during a five-day tendering window) on the price at which they would be willing to sell their shares to the acquiror.

A delisting offer can go through only if a sufficient number of shares are tendered by public shareholders, such that the acquiror (after also taking into account the shares that it already holds or is separately acquiring in the underlying negotiated transaction) would be able to reach 90% shareholding in the Listco (**Tendering Threshold**).

Based on the bids received:

a. If the Tendering Threshold is not met, then the delisting offer fails.

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[1] A delisting may be undertaken by either a new acquiror proposing to acquire >25% stake in or control over a listed company, or by an existing promoter (i.e., controlling shareholder) of the listed company. For simplicity, this update uses the term *'acquiror'* to refer to both a new acquiror and an existing promoter (in a delisting context).

[2] Shares of a listed company are considered to be *'frequently traded'* if the traded turnover of such shares on the stock exchange during the 240 trading days preceding the reference date is at least 10% of the total number of outstanding shares.

b. If the Tendering Threshold is met, then the delisting price is determined as the price at which the acquiror would be able to purchase such number of shares from public shareholders, as would enable the acquiror to reach 90% shareholding in the Listco (**Delisting Price**).

The acquiror is free to accept or reject the Delisting Price. If the acquiror accepts the Delisting Price, then the delisting succeeds and the acquiror must purchase, at the Delisting Price, all shares that were tendered at any price at or below the Delisting Price.

If the acquiror rejects the Delisting Price, then the delisting fails. Instead of rejecting the Delisting Price, the acquiror may make a *'counter-offer'* to public shareholders at a price that is not less than the book value of the Listco. If a counter-offer is made, then a new round of tendering by public shareholders takes place. The delisting succeeds if the Tendering Threshold is met at the counter-offer price.

2.3 Concerns with the reverse book building method

Market experience suggests that besides being overly complex, the RBB method has, more often than not, produced sub-optimal outcomes for stakeholders. The Delisting Price often ends up including an exorbitant premium (at times, more than 100%) over the Floor Price. This tends to be the case even though the Floor Price itself is a good proxy for fair market value (SEBI, in fact, considers the Floor Price as the fair offer price in the context of an open offer under the Takeover Code).

It is suspected that at least part of the reason for this trend may be rent-seeking behaviour by *'bad actors'* or speculators, who may pick up a sizeable position in the stock on the announcement of a delisting offer and then seek an unreasonable premium, thereby holding the acquiror as well as public shareholders to ransom. In effect, the RBB process makes it inefficient to take a Listco private, which has led to concerns about a chilling effect on public company M&A, more generally.

Leaving price discovery to public shareholders (who are not experts in valuation and have imperfect information) may also not be an effective way to achieve SEBI's intended policy objectives. The Delisting Regulations contain various other safeguards that are better suited to secure the interests of public shareholders. For instance, apart from the requirements relating to Floor Price and Tendering Threshold, a delisting offer requires the approval of a super-majority of shareholders, i.e., >75% of voting shareholders, including the approval of >66.66% of voting public shareholders. A duty is also cast upon the independent directors of the Listco to consider the fairness of the delisting offer and provide their reasoned recommendations to public shareholders to enable them to make a well-informed decision.

3 Proposed changes

3.1 'Fixed price' delisting

The Consultation Paper proposes to allow an acquiror to offer a fixed price to delist the shares of a Listco, as an alternative to the RBB method.

This will be implemented as follows:

a. The acquiror will be free to set the offer price for the delisting at any price at or above the Floor Price.

b. There will be no public bidding process for book building. Public shareholders would only need to decide whether or not to tender their shares at the fixed offer price.

c. If the Tendering Threshold (i.e., the acquiror being able to reach 90% shareholding in the Listco) is met at such fixed offer price, then the delisting offer will succeed. If the Tendering Threshold is not met, then the delisting will fail.

This is a significantly more streamlined process, which does away with much of the complexity of the RBB method. Importantly, this method leaves no room for speculation on the delisting price, which should help insulate the process from bad actors.

The Consultation Paper limits this proposal on '*fixed price*' delisting to Listcos with shares that are frequently traded, presumably because such shares have a clear market-discovered price.

While there is good basis to take a more cautious approach towards Listcos with shares that are not frequently traded, SEBI should consider making this method available even in such cases, given the other protections that are already available to public shareholders in the Delisting Regulations, as discussed above.

3.2 Revision to 'floor price'

The Consultation Paper proposes a change to the formula for the Floor Price by introducing an additional parameter, i.e., the *'adjusted book value'*, as computed by an independent valuer. The Floor Price will be the highest of the price determined in accordance with the parameters set out under the Takeover Code, as discussed above, and the adjusted book value.

While the intent may be to give additional confidence to public shareholders that the offer price accurately reflects fair value, there is good basis to argue that the existing regulations already address this, and the new insertion may add some incremental complexity that is avoidable, for the following reasons:

a. For Listcos with frequently traded shares, the market price is considered as an accurate measure of fair value (e.g., under the Takeover Code and under exchange control regulations) – the reason for deviating from this principle is not clear.

   If there is a concern that an acquiror may *'time'* the market by choosing to delist at a point when market prices are unusually depressed, a better alternative could be to pick up the market price over a longer trail-period in the formula for Floor Price (e.g., by also including the volume-weighted average trading price over the past 90 trading days, which is the metric used in determining the pricing for a preferential issuance of shares by a Listco).

b. The book value may not always be an accurate reflector of fair market value, particularly for companies operating in asset-intensive sectors. For this reason, where regulations require a valuation (e.g., for private companies under exchange control regulations), the specific method of valuation is generally kept flexible or left to the judgment of the valuer.

c. For Listcos with infrequently traded shares, the existing regulations already take into account valuation by an independent valuer based on valuation parameters that are customary to companies operating in the relevant sector.

3.3 Clarification of 'reference date'

The Consultation Paper proposes to rectify an anomaly in the calculation of the Floor Price by amending the *'reference date'*. The existing regulations define the reference date as the date on which the stock exchanges are notified of the board meeting at which the Listco approved the delisting offer. This refers to the intimation to be made to the stock exchanges following the conclusion of such board meeting.

However, under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, the Listco is also required to intimate the stock exchanges two business days in advance of the board meeting in which the delisting proposal will be considered. Separately, the Delisting Regulations require the acquiror to make an initial public announcement (**PA**) of the delisting. The board meeting of the Listco (to approve the delisting offer) may be held anytime within 21 days of the PA.

This results in a situation where there could be a time gap between (a) the information of the delisting first becoming known to the market and (b) the reference date for ascertaining the Floor Price. The volatility in the stock price during this period (e.g., on account of speculative activity in anticipation of the delisting offer) would, in turn, get reflected in the Floor Price. The Consultation Paper acknowledges that the floor price ought to be computed based on the *'undisturbed price'* of the stock, i.e., with reference to the period before the information of delisting is known to the market. Hence, the reference date is proposed to be changed to the date of the PA or the date of the advance intimation to the stock exchanges, as applicable.

4 Looking ahead

While SEBI's proposal is a progressive step, there is room to further rationalise the rules on take-private transactions.

Going forward, SEBI is expected to harmonise the *'combined-delisting-and-open-offer'* (**Combined Offer**) route under the Takeover Code with the changes proposed to the Delisting Regulations. While an amendment made to the Takeover Code in December 2021 did away with the RBB method and allowed delisting at a fixed price in a Combined Offer, this was subject to certain conditions, primarily, that:

a. this route was only available to a new acquiror (who did not hold >25% in the Listco and was neither associated with nor intended to acquire joint control with an existing promoter); and

b. the fixed offer price for delisting needed to include a *'suitable premium'* over the Floor Price and could not be less than the book value.

Given the proposed changes to the Delisting Regulations, these conditions should now be dropped from the Takeover Code, so that acquirors making a Combined Offer can also benefit from the more rationalised approach mooted in the Consultation Paper.

More generally, a clear and efficient mechanism is required to enable the acquiror to buy-out the residual minority shareholding (of up to 10%), which may remain even after the conclusion of a successful delisting. While the Companies Act, 2013 provides some options to implement such a squeeze-out (such as through a selective reduction of share capital with the approval of the National Company Law Tribunal), these options currently come with their own set of challenges, including the risk of protracted litigation. An efficient legal framework for squeezing-out the minority would enhance certainty for investors in control buy-outs.