M&A Hotline

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REVAMPING THE SCHEME OF ARRANGEMENT/AMALGAMATION REQUIREMENTS FOR LISTED ENTITIES – SEBI OVERHAULS THE REGULATORY FRAMEWORK!

- While keeping in line with the intention to protect shareholders of listed entities, SEBI has enhanced the scrutiny and disclosures in relation to listed entities engaging in schemes of arrangements.
- SEBI has laid special focus under the circular dated March 10, 2017 on mergers involving listed and unlisted entities.
- Ambiguities continue to exist in terms of schemes of arrangements especially in terms of listed entities merging with unlisted entities

BACKGROUND

In line with the decision at the Securities and Exchange Board of India ("**SEBI**") board meeting dated January 14, 2017 ("**Board Meeting**") to overhaul the regulatory framework governing schemes of arrangement, SEBI has issued a circular dated March 10, 2017 (the "**Circular**")[1] bringing in a fresh perspective to SEBI's regulatory role in relation to court / tribunal approved amalgamations.

Trends leading up to the Circular

By virtue of the various circulars dated September 3, 2009, February 4, 2013 (read with May 21, 2013) and November 30, 2015, SEBI imposed its oversight on schemes of arrangement being undertaken by listed companies under Section 391 – 394 of the Companies Act, 1956 (corresponding section 230 – 240 of the Companies Act, 2013). Earlier these schemes were only subject to obtaining no-objection letters from the stock exchanges on which the listed company was listed on and SEBI had a limited or no role to play by merely being able to provide their opinion on the scheme of arrangement. Since 2015, SEBI, upon an evaluation of the merits of the scheme of arrangement, would issue either a no-objection certificate or, in the event that the scheme of arrangement was irregular, an observation letter would be issued for the judicial authorities to consider. While SEBI has not deviated from this position, the extent of scrutiny and disclosures have increased by virtue of the Circular.

Prior to 2013, the mechanism for filing of a scheme of arrangement was extremely flexible, however, SEBI, in February 4, 2013, decided to widen the ambit of disclosures and requirements to be fulfilled by listed entities in terms of scheme of arrangements given that SEBI noticed various issues such as (i) inadequate disclosures by entities; (ii) convoluted schemes of arrangement; and (iii) exaggerated valuations computed under such schemes of arrangements.

Various regulations such as SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR Regulations**"), SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("**Takeover Code**") and SEBI (Securities Contract (Regulations) Rules, 1957 ("**SCRR**") have provided exemptions in relation to schemes of arrangement given that these schemes of arrangement were already scrutinized through overarching requirements of obtaining creditor and shareholder consent and additionally, obtaining the sanction of the courts in relation to such scheme of arrangement. For instance, in the event a listed entity were to undertake a scheme of arrangement, the acquisition of shares and control as a result of such scheme of arrangement was exempt from the open offer requirements of the Takeover Code.[2]

Accordingly acquisitions through this route provided great leeway to corporate entities to achieve the commercial objective without the hassle of requiring the approval or extensive scrutiny of SEBI. Additionally, the main principle that regulations such as ICDR Regulations, Takeover Code and SCRR were trying to achieve was already managed given the exhaustive approvals required in a court approved scheme.

However, given the fact that the spirit in terms of the existing laws was always focused towards ensuring that the interests and rights of the shareholders at large are protected, SEBI noticed certain circumstances wherein the spirit behind the exemptions was not always being achieved and in fact schemes of arrangements were actually used as means to circumvent the spirit of the law as opposed to the literal meaning of the regulations by SEBI.

Various listed entities that had filed schemes of arrangement before SEBI and the stock exchanges had received observation letters where SEBI had made observations with respect to the scheme of arrangement citing that the scheme is a) an attempt by listed entities to circumvent applicable provisions of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 where substantial acquisition of the shares of the resulting company was made by certain person, who may or may not be the promoters, without providing any exit opportunity to the public shareholders of the listed entity; and b) an attempt by unlisted entities (that merge with listed companies) to achieve

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listed status in circumvention of the requirements under the Securities Contract (Regulation) Rules, 1957 ("**SCRR**") and the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009. [3]

However, there was ambiguity in terms of how to evaluate such schemes wherein the spirit of the regulations framed by SEBI may be violated. Given that there was a clear lack of guidance in terms of evaluating such schemes, SEBI passed the Circular in order to combat such ambiguity and regulate the schemes of arrangement in a manner so as to uphold the spirit of the regulations and law.

All schemes of arrangement on or post March 10, 2017 are to be governed by the Circular. Essentially, the Circular, prospectively, replaces the erstwhile framework detailed in the circular dated November 30, 2015 with the aim to infuse a robust design to secure the integrity of the securities markets.

SNAPSHOT AND ANALYSIS OF THE CIRCULAR

While, the requirements before the scheme of arrangement is submitted to the court/tribunal and after the scheme of arrangement is sanctioned remains relatively the same as the circular dated November 30, 2015, the Circular has increased requirements in terms of scrutiny and disclosures, while also extending focus towards requirements for schemes of arrangements involving between listed companies and unlisted companies.

To put it simply, all other requirements in relation to the designated stock exchanges, valuation report, requirement of auditors certificate, redressal of complaints, obligations of the stock exchanges and processing of the draft scheme of arrangement have been replicated as specified under the circular issued of November 30, 2015 issued by SEBI. However, the following requirements have been now added in relation to schemes of arrangements:

I. Pricing

Issuance of shares under such schemes of arrangement, where shares are to be allotted to a select group of shareholders or shareholders of unlisted companies are now be subjected to pricing norms as prescribed under the ICDR Regulations which were applicable in case of preferential allotment of shares. While the Circular does not specifically state when the price of the shares under these schemes of arrangement are to be computed or rather the "relevant date" (as prescribed under the ICDR Regulations), SEBI has issued a clarification on March 23, 2017, that the "relevant date", for the purpose of computing the price of the shares, shall be the date of the board meeting of such company passing the scheme of arrangement.[4] Therefore in some aspects, SEBI has intervened in how such companies determine 'fair value' and the swap ratio by prescribing a minimum threshold.

However, certain aspects of this provision may need further clarity, as explained below:

1. Firstly, as per the Circular, the pricing norms are applicable only in cases where 'shares' are allotted (pursuant to a scheme of arrangement) to a 'select group of shareholders' or 'shareholders of unlisted companies'. This does not factor in situations where the consideration may be something other than shares. Therefore if a listed company undertakes a scheme of arrangement that results in such shareholders receiving only cash, there appears to be no minimum value that needs to be taken into consideration. Further, it should be clarified that 'shares' means 'equity shares' or 'convertible securities' as the pricing norms under the ICDR Regulations are only limited to pricing of equity instruments.
2. Secondly, there is little clarity on the scope of the term "shares are allotted to a select group of shareholders". While SEBI's intent may be to ensure parity between shareholders, the language adopted could be interpreted to mean that no shareholder can be afforded the option the flexibility to choose between shares and other forms of consideration as this may result in only a 'select group' being allotted shares. This could significantly impact the flexibility afforded to parties while structuring schemes of arrangement. Further, SEBI may also clarify that the term 'shareholder' (in the phrase "select group of shareholders") refers to equity shareholders of the transferor company, as holders of redeemable preference shares etc. of a transferor company will not be allotted equity shares of the transferee company pursuant to a scheme of arrangement.
3. Thirdly, while the Circular provides for pricing norms in case of allotment of shares to 'shareholders of unlisted companies' (i.e. merger of unlisted company with a listed company), there is no guidance on whether the pricing norms are applicable in case of allotment of shares to 'shareholders of listed companies' (i.e. merger of listed company with a unlisted company). The intention of SEBI may not have been to exempt reverse mergers from the ambit of the pricing norms given the issues which have arisen in the past and hence, SEBI may issue an appropriate clarification in this regard.

II. Schemes of arrangements between listed entities and unlisted entities

The following requirements have been specified in relation to schemes of arrangements between listed entities and unlisted entities:

1. The listed entity is required to provide information in regards to the unlisted entity in the format specified for abridged prospectus in the explanatory statement / notice / proposal sent to the shareholders while for seeking their approval for the scheme of arrangement which is similar to the manner undertaken in an initial public offering. Additionally, the accuracy and adequacy of such disclosures should be certified by SEBI registered Merchant Banker post undertaking due diligence process.
2. The percentage of shareholding of pre-scheme public shareholders of the listed entity and the Qualified Institutional Buyers ("**QIBs**") of the unlisted entity shall not be less than 25% of the post-merger shareholding pattern of the resultant company. This may actually be considered as a relaxation provided by SEBI since the erstwhile circulars issued by SEBI required that the pre-scheme public shareholders of the listed entity hold not less than 25% of the post-merger shareholding patten of resultant company..
3. Unlisted entities can be merged only with listed entities listed on Stock Exchanges having nationwide trading terminals.

III. Submission of documents

In addition to the documents that were previously submitted by the listed entity such as the draft scheme of

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arrangement, valuation report and report from the audit committee recommending the scheme (such report must be placed before the audit committee of the listed entity) etc., as specified under the circular issued on November 30, 2015 by SEBI, SEBI has specified that the requirement of a detailed self-compliance report as per the format specified under the Circular to be duly certified by company secretary, chief financial officer and managing director confirming regulatory and accounting compliances (to be additionally uploaded on the website of the listed entity and websites of stock exchanges).

IV. Approval of Shareholders to Scheme through e-Voting

The listed entities must ensure that the scheme submitted with the court/tribunal for sanction, provides for voting by public shareholders through e-voting, after disclosure of material facts in the explanatory statement sent across to such shareholders. This mechanism has been purely introduced with the purpose of ensuring there is no interference by the promoters in terms of the voting mechanism.[5]

Apart from the schemes of arrangements specified under the circular dated November 30, 2015 by SEBI, the following additional schemes of arrangement can be acted upon only if the majority of the public shareholders vote in favour of such a scheme:

1. Schemes of arrangements involving the merger of an unlisted entity results in reduction in the voting share of the pre-scheme public shareholders of listed entity in the transferee/resultant company by more than 5% of the total capital of the merged entity.
2. Where the scheme involves transfer of whole or substantially the whole of the undertaking of the listed entity and the consideration is not in the form of listed equity shares.

V. Processing of the scheme by SEBI

Now SEBI can seek clarifications from any person relevant to the scheme of arrangement and may also seek an opinion from an independent chartered accountant while scrutinizing the draft scheme of arrangement. Furthermore, in the past, SEBI has seen that changes to the draft scheme to be filed before the court/tribunal have been made post SEBI issuing its observation letter. In light of the same, SEBI has provided under the Circular that no changes are to be made to the draft scheme except those mandated by the regulators/authorities/tribunal without the specific written consent of SEBI.

VI. Merger of a listed entity into an unlisted entity

Section 19 of the SCRR provides the procedure to be followed by a public company in order to have its shares listed on a recognized stock exchange in India. Often, unlisted companies sought approvals to schemes of arrangements for mergers with listed (transferor) entities: an approval to such a scheme would have enabled the securities of the unlisted (transferee) entity to be listed on a stock exchange without having complied with the strict vetting procedure that has been put in place under the SCRR. SEBI, with the view to maintain the integrity of the markets had often issued observation letters to entities that had attempted to circumvent the strict enforcement of the SCRR. However, there was a need felt to have in place a procedural mechanism for objective adjudication of bona fide arrangements. While the Circular has replicated most of the requirements as specified under the circular dated November 30, 2015 issued by SEBI, certain requirements have been tweaked/expanded significantly:

1. The eligibility criteria:

In order to avail of a relaxation from Rule 19 (2) of the SCRR (which provides for the satisfaction of the relevant stock exchange that (i) the articles of the company are in order; and (ii) that at least 10% (ten percent) had been offered to the public for subscription in the manner stipulated), a company must satisfy the following conditions which were also specified under the circular issued on November 30, 2015 by SEBI:

1. The equity shares of the unlisted entity sought to be listed pursuant to the scheme of arrangement are to be allotted only to the shareholders of the listed entity;
2. At least 25% (twenty-five percent) of the paid-up share capital of the resulting entity shall comprise the shares allotted to the public shareholders of the erstwhile listed entity. This requirement was specifically to ensure that unlisted entities do not attempt to list with shell companies which are listed for the purposes of gaining listing benefit;
3. There shall be no issuance/ re-issuance of shares that have not been covered in the draft scheme of arrangement;
4. On the date on which the scheme is filed, there are no outstanding warrants, options arrangements, agreements and/ or any other instruments which gives any right to any person to take equity shares in the resulting entity at any future date, however, if there are such instruments stipulated in the draft scheme, the percentage, that is 25% of the post scheme paid up share capital as specified under (ii), shall be computed after assuming that the options or instruments are fully converted and then the shareholding shall be computed;
5. The lock-in period applicable to the shares of the listed entity will stand transferred to the shares of the resultant entity and such shares will be subject to lock-in for the remaining period.

2. Additional Compliances: The Circular stipulates that an application by way of filing the draft scheme of arrangement with the stock exchanges must be ensured by listed entity for availing the exemption under the SCRR and upon sanction of the scheme of arrangement and allotment of securities, the stock exchanges are required to ensure that unlisted entities apply for an exemption under the SCRR. This requirement was also stipulated under the circular issued on November 30, 2015.

3. Lock-in: In the event of a de-merger or a hive-off of a business segment into an unlisted entity, it has been clarified that the entire share capital of the unlisted entity, prior to the scheme of arrangement coming into force, shall be locked in from the date of listing of its shares. This measure seeks to ensure that only bona fide deals are allowed to avail of the exemptions from the SCRR. Accordingly, the Circular stipulates that the shares held by the promoter(s), up to a maximum of 20% (twenty percent) of the paid up share capital of the resultant company, be locked-in for a period of 3 (three) years from the date of listing. The lock-in period for all other shares is limited to one from the date

of listing. Interestingly, this condition of lock-in will not apply to a resulting entity wherein the shareholding is exactly similar to the shareholding of the erstwhile listed entity. However, it is to be noted that under the Circular, perhaps accidently, omits the requirement for a lock in period in case of a *simpliciter* merger where promoters' shares were to be locked in to the extent of 20% of the post-merger paid up capital of the unlisted issuer, for a period of 3 years from the date of listing of shares of the unlisted entity and the balance of the entire pre-merger capital of the unlisted issuer was to be locked in for a period of 3 years from the date of listing of shares of the unlisted entity. It is likely that a clarification or an addendum restating this will be provided by SEBI as this miss would seem to be unintentional given the framework governing such schemes of arrangements.

VII. Other Requirements

The Circular also provides additional requirements that the resultant entity must comply with in order to list shares having any form of differential rights. In order to avail of the relaxations from the SCRR, the resultant entity must demonstrate that the shares having differential rights have been issued to all existing shareholders by way of a rights issue and/ or bonus issue, and that all conditions for minimum public shareholding has been complied.

CONCLUSION

SEBI has attempted to balance the need to protect the interests of investors and the integrity of the markets against sound commercial and economic rationale of the business community. Additionally, given the recent amendments and decisions of SEBI towards ensuring a strong corporate governance, the Circular reflects such an intent to ensure that processes are in place for listed entities to comply with all corporate governance and disclosure requirements while keeping up with the intent of SEBI to ensure that the shareholders of the listed entities are protected

From a commercial perspective, although certain flexibilities have been lost in structuring transactions between listed companies and unlisted companies, this Circular may provide for some amount of deal certainty without fearing SEBI adverse objections on what could otherwise be seen as complying with the written law. There are certain clarifications that are still awaited from the SEBI on the Circular which we envisage will be provided shortly.

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You can direct your queries or comments to the authors

1 http://www.sebi.gov.in/cms/sebi_data/attachdocs/1489148947403.pdf (Last seen April 3, 2017).
2 As provided under Section 3 and Section 4 of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011, no acquirer shall neither acquire shares or voting rights in a target company which taken together with shares or voting rights, if any, held by him and by persons acting in concert with him in such target company, entitle them to exercise 25% or more of the voting rights in such target company nor shall acquire, directly or indirectly, control over such target company unless the acquirer makes a public announcement of an open offer to acquire the shares of the target company. http://www.sebi.gov.in/cms/sebi_data/commondocs/acquistionofshares.pdf (Last seen April 3, 2017).
3 SEBI Observation Letter CFD/DIL/AKD/PHV/OW/15115/2014 dated May 26, 2014, available at http://palred.com/pdf/merger/SEBI%20Observation%20Ltr_PTL.pdf (last seen April 3, 2017); Also see, Observation Letter DCS/AMAL
4 http://www.sebi.gov.in/cms/sebi_data/attachdocs/1490268460576.pdf (last seen April 3, 2017).
5 http://www.sebi.gov.in/cms/sebi_data/boardmeeting/1485171547206-a.pdf (Last seen April 3, 2017).