Analysis

Identification of Promoter and Promoter Group

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Promoter identification is an important cornerstone of the regulations governing Initial Public Offerings (IPOs) in India. One of the key considerations for a private equity investor eyeing an IPO as an exit mechanism is whether an investment will ultimately result in it being identified as a promoter at the public issue stage.

Introduction

IPOs are an important exit route for private equity (PE) investors in India and are governed by the Securities Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR Regulations) and the Companies Act, 2013. The ICDR Regulations require that promoters be clearly identified in the draft red herring prospectus. Further, to ensure that promoters have skin in the game after the IPO, the ICDR Regulations place various obligations on the promoters such as a 20% minimum shareholding in the post-issue share capital of the company and lock-in restriction of three years on such shareholding. There are also onerous disclosure requirements on promoters under the ICDR Regulations.

However, being identified as a promoter of an investee company (Company) may not be conducive for a PE investor especially for those investors targeting an IPO as an exit mechanism for their investment. Therefore, it is important for a PE investor to understand the key requirements to be classified as a promoter under the ICDR Regulations, including disclosure requirements relating to members of promoter group entities.

In this newsletter, we analyse the key requirements and criteria for classification as a promoter and identification of members of promoter group entities as per the ICDR Regulations. We also discuss the exemptions available to certain persons and entities from such classification and inadvertent scenarios where such a classification may ensue.

Who can be a promoter?

Under the ICDR regulations, a person may be classified as a promoter if:

(a) such person is named as a promoter in the draft offer document, offer document or annual returns filed by the Company, or

(b) such person has ‘control’ over the affairs of the Company (either directly or indirectly), or

(c) the board of directors of the Company acts in accordance with the advice or instructions of such person.

Further, ‘control’ has been defined in the Companies Act and SEBI (Substantial Acquisition of Shares and Takeovers)
Regulations, 2011 (Takeover Code) to mean: (i) the right to appoint majority directors or (ii) 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, management rights, an agreement or in any other manner.

Persons exempted from being classified as promoters

The ICDR Regulations categorically exempt persons advising the board of directors merely in their professional capacity from being classified as promoters. Further, financial institutions, scheduled commercial banks, foreign portfolio investors (FPI) (other than individuals, corporate bodies and family offices), mutual funds, venture capital funds, alternative investment funds, foreign venture capital investors, insurance companies or any other category of entities as specified by SEBI, who in their capacity as investors hold 20% or more in the equity share capital of the Company are also exempted from being classified as promoters.

What PE investors should consider while negotiating special rights in the Company?

Whether a PE investor may be classified as a promoter of a Company is largely based on the shareholding and control exerted by the PE investor in the Company.

Listed below are three possible scenarios in which a discussion on the definition of ‘promoter’ becomes relevant, along with key considerations for PE investors while negotiating special rights in a Company.

(a) **PE investor is a minority shareholder and there are other majority shareholders**

In this scenario, it is highly unlikely that a PE investor may be identified as a ‘promoter’ since the PE investor does not have control over the affairs of the Company, and the board of directors would not act in accordance with such investor’s advice.

Even if a minority holding PE investor is granted certain special rights through the constitutional documents of a Company or through agreements such as shareholder's agreement, such special rights are usually limited to rights such as appointment of a nominee director or information rights. However, due care should be taken by a PE investor while negotiating for such special rights to ensure that these rights do not tantamount to 'control' as defined under the Takeover Code.

However, the PE investor should ensure that the annual returns, draft offer document, offer document, regulatory filings, corporate filings, licences or any other material contracts such as shareholders’ agreements or loan documentation do not identify the PE investor as a promoter of the Company.

(b) **PE investor has 25% or more shareholding, along with other majority shareholders**

In this scenario, the likelihood of the PE investor being viewed as a ‘promoter’ in the Company is higher. By virtue of such shareholding, the PE investor would have some enhanced special rights such as the right to appoint a majority of the directors, affirmative rights and reserved matter rights over the functioning of the Company. Therefore, in such a case, the PE investor must exercise caution to ensure that such additional special rights are not considered as ‘control’ under the Takeover Code.

In order to preclude such an interpretation, a PE investor could consider including a provision in the constitutional documents of the Company and in the shareholders’ agreements that the special rights of the investor will automatically fall away when the equity shares of the Company are listed. Pursuant to this, the PE investors will not enjoy any rights in the Company which are disproportionate to their holdings. Further, there can be a provision to reinstate such rights, in case the IPO is withdrawn or not successful.

Further, as in the case of minority shareholding, care must also be taken to ensure that the annual returns, draft offer document, offer document, regulatory filings, corporate filings, licences or any other material contracts such as shareholders’ agreements or loan documentation do not identify the PE investor as a promoter of the Company.

(c) **PE investor is the majority shareholder**

Where a PE investor is the majority shareholder in a Company and there is no other shareholder who fits the criteria to be identified as a promoter, it is most likely that the PE investor will be identified as a promoter. Further, it is likely that in such
a scenario, the PE investor would hold special rights in the Company which would also trigger the requirement of 'control' under the Takeover Code.

PE investors who do not wish to be identified as promoters of a Company could take the route of identifying the Company as 'a professionally managed company with no identifiable promoters'. In order to do this, PE investors while negotiating their special rights should ensure that such rights do not impinge on the following:

(i) the Company should be professionally managed with an independent board of directors,
(ii) the board of directors of such Company should not have an obligation to act upon the advice or directions of the PE investor,
(iii) decisions by the board of directors are taken by a majority vote,
(iv) the day to day operations is carried out by professionals who report to the board of directors,
(v) the PE investor must not be granted any right to appoint key managerial personnel,
(vi) the director nominated by the PE investor on the board of directors of the Company should not have any contractual rights which will entitle him/her to influence the board or management decisions.

Recently in India, companies such as Equitas Holdings Limited, Tejas Networks Limited, Ujjivan Financial Services Limited, and Indian Energy Exchange Limited have listed their equity shares on the stock exchanges without having an identifiable promoter despite one or more shareholder(s) having substantial shareholding in such companies. These companies have disclosed in their offer documents that they are a professionally managed entity and do not have any identifiable promoter(s).

Identification of promoters where investments are through multi-layered entities

Often, PE investors structure their investments into a Company through multi-layered entities, with the immediate holding entity of the Company being merely an investment vehicle and not a substantive entity. Therefore, in order to identify the entity exercising ultimate control over the Company, a case to case factual analysis is required to be carried out to examine the structure of investment, based on the following:

The promoter entity should:

(a) be a substantive entity and not merely an entity created for holding investments.
(b) operate as a separate entity with its own independent decision-making mechanism.
(c) not act on the instructions of any other entity.

Who can be classified as a member of a Promoter Group?

In addition to disclosing the identity of a promoter, another related disclosure requirement under the ICDR Regulations is the identification of members of a promoter group. The ICDR Regulations provide for a mechanism to identify members of a promoter group. Such members are required to provide certain confirmations and disclosures in the offer documents.

The illustration below sets out the manner in which members of a promoter group will be identified when a corporate entity is identified as a promoter:
The persons identified in square boxes in the figure above will be identified as members of the promoter group.

Abbreviations:

- **C** - The Company proposing to undertake the IPO
- **P** - Promoter
- **S** - Any subsidiary of the Promoter
- **H** - Holding company of the Promoter
- **B** - Any company which holds 20% or more of the equity capital of the Promoter
- **A** - Any company in which the Promoter holds 20% or more of the equity capital
- **M** - A group of companies or individuals or combination thereof who hold 20% or more of the equity capital in the Company and also in another company (L)

Financial institutions scheduled commercial banks, FPIs, mutual funds, venture capital funds, alternative investment funds, foreign venture capital investors and insurance companies or any other category of persons as specified by the SEBI are not classified as members of a promoter group merely by virtue of holding 20% or more in the promoter entity.

However, such entities will be classified as a member of the promoter group for the subsidiaries or companies promoted by them, or the mutual funds sponsored by them.

**Conflict or disassociation between members of a Promoter Group**

Although ICDR Regulations require members of a promoter group to provide certain confirmations and disclosures in offer documents, obtaining such information may not possible at times when there is a disassociation between members of the promoter group and the promoter, or a conflict between such entities.

In such a scenario, companies can approach SEBI for an exemption from the disclosure requirements applicable to such promoter group entities under the ICDR Regulations. SEBI may grant an exemption if it is satisfied that the Company is incapable of procuring such information.

The inability of the Company in procuring such information can be demonstrated to SEBI through demonstration of the presence of the following facts:

(a) a complete severance of ties between members of the promoter group and the promoter of the Company;

(b) members of the promoter group for whom an exemption has been sought have no ownership, management or control
rights in the Company;

(c) neither the Company, its directors and promoters, nor the entities controlled by them have any professional interaction
or correspondence or business relationship with members of the promoter group;

(d) separation of business interests between members of the promoter group and the promoter through a separation
agreement or such other arrangements.

Conclusion

The identification and track record of promoters is an important yardstick used by investors in assessing a company's
prospects and therefore the ICDR Regulations heavily regulate this aspect to ensure that promoters are held accountable.
However, the requirements under the ICDR Regulations can become very onerous for PE investors especially when other
companies in which a PE investor has invested, become part of the promoter group.

Therefore, PE investors who do not intend to become promoters of their investee companies and intend to exit their
investments through a public offering must carefully consider negotiating their rights in the Company at the time of making
their investment so as to ensure that such rights do not trigger the requirements of the ICDR Regulations in relation to
identification of promoters.

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