

Corpsec Hotline

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RE-CLASSIFICATION OF PROMOTERS: AN INFLECTION POINT FOR INDIA INC.?

Concentrated promoter shareholdings have typically been the mandate in Indian companies till date.¹ Hence, it is not much of a surprise that the significance of promoters in Indian companies can have large implications from a legal standpoint. However, the traditional ownership structure of Indian companies has undergone a paradigm shift in recent times with private equity funds and institutional investors acquiring substantial stakes in Indian companies which do not have a distinctly identifiable promoter group. There has been a monumental rise in control transactions in Indian markets, akin to those in the US, wherein the investors are in control of the company since they have board seats, control rights and veto rights.

In order to keep up with changing times, SEBI in its Board meeting dated August 6, 2021² gave an in principle approval to shift from the concept of the promoter to 'controlling shareholders' as was proposed in the Consultation Paper dated May 11, 2021 which dealt with the review of framework pertaining to promoters and the promoter group.³ Though the Consultation Paper dealt with other aspects such as reduction in lock-in period for minimum contribution of promoters, rationalization of definition of the promoter group streamlining the disclosure requirements for group companies, one of the key changes, which appears to be a labelling change is the introduction of the concept of 'controlling shareholders'. The ramifications of the same must be ruminated closely prior to implementing it. We have discussed the probable impact of the contemplated changes below.

DEFINITION OF PROMOTER

The Companies Act 2013,⁴ as well as the SEBI (Issue of Capital and Disclosure Requirements) Regulations⁵, 2018 defines the term 'Promoter' as:

1. A person who has been named as such in a prospectus or is identified by the company in the annual return in section 92; or
2. A person who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or
3. A person who is in agreement with whose advice, directions or instructions the Board of Directors of the company is accustomed to act.

As per SEBI's Consultation Paper, a controlling shareholder is proposed to be defined as '*A person who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise*'.⁶ The concept of controlling shareholder would streamline the approach taken by regulators while imposing any obligations and shifting the onus of adhering to statutory obligations over to the controlling shareholders. Such a change may absolve promoters from the mandate of '*once a promoter, always a promoter*'.

In light of the same, it becomes pertinent to understand the interpretation of control under the Indian corporate regime.

INTERPRETATION OF CONTROL

Regulation 2(1)(e) of Takeover Regulations, 2011 has defined 'control' as 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. Control has been defined in a similar manner under Section 2(27) of the Companies Act, 2013 as well.

Although SEBI's interpretation of the term 'control' has been oscillating, in *Subhkam Ventures v SEBI*,⁷ SEBI opined that protective covenants, such as affirmative votes extended to the nominee director of the investor on matters such as amendment of the articles of association, changes in share capital, approval of the annual business plan, restructuring of the investee company, the appointment of key officials of the company, etc. qualifies as acquisition of control by the investor. However, on appeal, SAT observed that control is a power by which on one hand an investor can command a company to do what it wants to do. It was also clarified by SAT that the power by which an acquirer can prevent a company from doing what the latter wants to do cannot by itself qualify as 'control'. SEBI appealed against the SAT order before the Supreme Court. However, the Supreme Court could not take a stand due to withdrawal of the case due to the exit of the investor.

In the case of *Kamat Hotels v SEBI*,⁸ interpretation of 'control' came up before the Whole Time Member ("WTM") of SEBI for adjudication. The WTM had to decide, *inter alia*, whether there had been an acquisition of control by the Noticees merely by virtue of entering into an agreement under which they were granted certain rights which would trigger an open offer under the Takeover Code 1997. The WTM ruled that the determination of 'control' due to the

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presence of affirmative voting rights, in light of the facts of the case, was irrelevant. The WTM, with regard to the rights available to the Noticees under the Agreement (mentioned above), made an obiter dictum in its order: *"It is apparent that the scope of the covenants in general is to enable the Noticees to exercise certain checks and controls on the existing management for the purpose of protecting their interest as investors rather than formulating policies to run the Target Company"*. However, since the Agreement was terminated in July 31, 2014, and the clauses that purportedly conferred 'control' on the Noticees under the Agreement were no longer binding on the promoters of KHL; consequently the WTM decided that the determination of 'control' was no longer relevant.

Basis past precedents, it appears that determination of 'control' stems from certain principles which when applied to a given set of facts and circumstances, provides scope for different interpretations.

In the same context, SEBI floated a consultation paper dated March 2016⁹ in which the definition of 'control' under the Takeover Regulations was considered to be amended as: *"(a) the right or entitlement to exercise at least 25% of voting rights of a company irrespective of whether such holdings give de facto control and/or (b) the right to appoint majority of the non-independent directors of a company"*. However, the same has not yet been implemented.

Surprisingly enough, the whole exercise of transitioning from promoters to controlling shareholders will prove to be futile unless SEBI adequately addresses the elephant in the room, i.e. definition of 'control'.

CONCLUDING REMARKS

The investor landscape in India has considerably changed over time. While historically, Indian companies have witnessed concentration of promoter ownership and control, they are currently being replaced by private equity and institutional investors who acquire substantial stakes in the companies, sometimes amounting to control. In the case of new age start-ups like Paytm and Zomato which are being listed on Indian bourses, it can be observed that the promoters/founders of these companies own less than 20 percent.¹⁰ Such investors continue to stay invested in unlisted companies until they go public, by virtue of which they have special rights in these companies such as the right to nominate directors.

Due to these evolving changes in shareholding patterns, it is only rational for SEBI to introduce the concept of controlling shareholders since promoters with no controlling rights and minority shareholding casting influence over companies (by virtue of them being classified as Promoters) is not in the best interests of the stakeholders involved.

Doing away with the concept of promoters is likely to accord flexibility to the Promoters in terms of lesser compliances and disclosure requirements under law and at the same time allow companies to be more professionally managed instead of being promoter driven.

On the flip side, since the Promoters are in charge of the day to day operations of the company and the investors (irrespective of their large equity holding) do not participate in the operational matters, it will be difficult to draw the line on the promoters to the effect that because they are not controlling shareholders, they will not be liable for the compliances/ defaults etc by the company. Accordingly, it needs to be analysed whether the controlling shareholders (which in most cases could be financial or strategic investors) are amenable to the new proposal and what contractual/ statutory consequences may ensue from an investor standpoint, if this proposal is accepted.

The fact that SEBI is ruminating such a change is a clear indication of the maturity in Indian Capital Markets. However, while implementing the contemplated changes, SEBI must not ignore the importance of non-controlling shareholders in Indian companies and the fine balance to be drawn between the persons in charge of the operations of the company vis a vis financial investors.

— Eshvar Girish & Harshita Srivastava

You can direct your queries or comments to the authors

¹ <https://www.oecd.org/corporate/ownership-structure-listed-companies-india.pdf>

² https://www.sebi.gov.in/media/press-releases/aug-2021/sebi-board-meeting_51707.html

³ SEBI's consultation paper on 'Review of the regulatory framework of promoter, promoter group and group companies as per Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018' https://www.sebi.gov.in/reports-and-statistics/reports/may-2021/consultation-paper-on-review-of-the-regulatory-framework-of-promoter-promoter-group-and-group-companies-as-per-securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-re_50099.html

⁴ Section 2(69), Companies Act, 2013

⁵ Regulation 2 (oo), SEBI ICDR Regulations, 2018

⁶ The concept of controlling shareholder would be narrowed down to Section 2(69)(ii) of Companies Act, 2013

⁷ Civil Appeal No. 3371 of 2010

⁸ https://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/newsid/3960/html/1.html?no_cache=1

⁹ https://www.sebi.gov.in/sebi_data/attachdocs/1457945258522.pdf

¹⁰ As per Regulation 14(1) of SEBI ICDR Regulations, 2018, the minimum contribution of the promoter is required to be 20% shareholding before the company goes public.

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