The Curious Case of Group Companies

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Companies undertaking an initial public offering **("IPO")** in India are subject to a robust disclosure regime, particularly under SEBI's regulations governing public offerings. IPO disclosures extend not merely to the issuer or its subsidiaries/ holding companies, but several other connected individuals and entities. An IPO-bound issuer governed earlier by simpler regulatory climes, realizes overnight that it has spawned promoters, a promoter group and group companies. An informal or generic understanding of these terms, used oft with aplomb in investment and shareholder agreements, is no longer kosher – an IPO company must apply SEBI's tests to identify them. This is likely the easy part – the harder is to analyze the information required from these persons and entities and obtain (often extricate) such information.

Most members of the issuer's IPO-born family continue, and like the promoters and promoter group, assume important stature in its post-listing avatar. Not all, though. Perhaps most esoteric of SEBI's brood is the "group company", a creature that lives and breathes only in the issuer's offer documents. Yet for this curious ephemeral entity, SEBI has traditionally reserved some of its most stringent disclosure dictates, much to the wonder and bafflement of issuers, lead managers and other stakeholders in the IPO process. This article discusses the evolving regulatory regime governing group companies, the challenges and conundrums faced, and the solutions posted.

Group Companies – evolving definitions and challenges

The definition of the term "group company" has seen a fair share of regulatory re-imagination. The formulation that lasted the longest, identified group companies as "companies, firms, ventures etc., promoted by the promoter…" This definition was set forth in the (erstwhile) Securities and Exchange Board of India (Disclosure and Investor Protection Guidelines), 2000, and brought forward in in SEBI's celebrated Issue of Capital and Disclosure Requirements, 2009 **("ICDR Regulations")**. The term "promoted by the promoter" was understood with reference to the definitions of "promoter", and eventually of "control", to include all companies, firms, ventures, etc., which were controlled by the promoter of the IPO company.

While unblemished at first glance, this definition posted certain problems. The definition of "control" itself being celebrated in its complexity (particularly when tested for "firms" and "ventures"), issuers often erred on the side of caution and identified numerous entities as its group companies. For large corporate groups, group companies ballooned into the hundreds. Samvardhana Motherson, in 2011 and Bharti Infratel, in 2012, as notable instances, listed over 100 entities as their group companies. Identification, as step one was exacerbated with disclosure – for group companies, the ICDR Regulations mandated disclosure of financial information (for the top five), incorporation details and other key corporate information, a brief description of their business, the financial and business interests of the issuer, its promoters and directors in group companies and pending litigation involving all group companies. To amass such information from dissipated and scattered entities made this exercise herculean. As a long-lead item, issuers were often advised at the commencement of their IPO process to reach out to other (sometimes off-the-radar) ventures of their promoters, so that the information would be in place before the draft offer document went on file.

Amendment in 2015

Relief, to some extent, came in August 2015. In an amendment that included revolutionary disclosure cut-backs, SEBI changed the definition of group companies to "include companies as covered under the applicable accounting standards and also other companies as considered material by the board of the issuer". The use of the term "companies covered under applicable accounting standards" behooved the question "Which was the applicable accounting standard?" While some initial confusion ensued on whether the relevant standard should be ICAI's Accounting Standard 21 on consolidated financial statements or Accounting Standard 18 **("AS 18")** on related party transactions, since SEBI's board agenda approving this amendment mentioned AS 18 as the relevant accounting standard, the legal test of group companies became an accounting test for related parties. Further, given the usage of the word "companies" in the new definition, firms, ventures, or other non-body corporate entities were now excluded.

While increasing clarity to an extent, kinks soon appeared in the definition. First, it was unclear whether related parties included only in the latest financial statements of the issuer were required to be identified as group companies, or if they should include related parties for all periods for which financial statements were disclosed in IPO offer documents. Second, the definition did not clarify if the check for related parties would be run as at the date of the offer documents, or as at the last date of the fiscal (or interim period) for which financial statements were included in the IPO offer documents. Third, the definition, through its use of "other companies as considered material by the board" introduced a new and subjective participant in the identification process. In effect, SEBI had created a sub-set of materiality without identifying either the universe where this materiality would be applied, or the parameters for its determination. In addition, there was little clarity on whether promoters, holding companies and subsidiaries, for which separate disclosures were mandated under the ICDR Regulations, would be considered group companies, since they would be reported as the issuer's related parties in its financial statements. The initial phase of the post-2015 amendment was characterized by issuers and market participants devising hybrid tests to identify group companies with varying levels of complexity, including one that suggested the aggregating, year-by-year, of all companies for which transactions were reported in the issuer's financial statements.

Furthermore, AS 18 characterized significant shareholders, and entities over which directors had significant influence as related parties. This meant that private equity investors and their affiliates were re-christened group companies. This added to the atmosphere of confusion, since PE players were none too happy to make key information (including financial line items) privy to the world at large. Certain issuers therefore, deemed it necessary to proactively exclude financial investors from the definition of group companies, even though the ICDR did not provide such expressed carve-out.

After considerable deliberation and informal feedback from SEBI, the dust around these issues largely settled. The test was envisaged to be run on financial statements of all periods included in the IPO offer documents and was updated to (a) add new companies which became related parties after the last date of the financial statements included in the offer document, and (b) remove companies no longer considered related parties since then. As practice, issuers excluded financial investors from the test, which passed regulatory muster. The test for materiality was, without much reason as it would appear, applied to companies forming part of the issuer's promoter group (defined as entities where promoters' shareholding was higher than the specified thresholds) with which the issuer had undertaken transactions above a certain value. The practice of including or excluding promoters, holding companies and subsidiaries remained varied in the market.

A third practice that remained less settled was if group companies included all related parties of the issuer or only those with which the issuer had transacted in the relevant financial periods. This stemmed from the fact that the financial statements and schedules of issuers listed out related parties in different manners: some included a complete list of related parties (irrespective of transactions), and others, only entities which had corresponding transactions with the issuer.

All in all, the new definition (and the practice which evolved to give effect to it), where the list of group companies was relatively easy to prepare or source, coupled with trimming of disclosures by SEBI, particularly relating to litigation, made identification and related disclosures in relation to group companies easier. The argument, however, against the efficacy and need for these disclosures remained.

Winds of change – the amendment of 2018

In June 2017, SEBI constituted a committee chaired by Mr. Prithvi Haldea to review its regulatory framework on capital raising. The initiative was aimed at simplifying language and interpretational nuances and updating these regulations for changes in the regulatory environment. The committee's suggested amendments were placed before SEBI's primary market advisory committee. Subsequently, a consultation paper was released earlier this year in May, along with a draft of the re-hauled ICDR Regulations for public comments. Following receipt and deliberation of comments, SEBI's board, on June 21, 2018, approved the new ICDR Regulations, which are to completely replace its battle-weary predecessor.

Though the amended regulations are yet to be notified, and the final language may differ from the draft released with the discussion paper, according to the press release by SEBI following the amendment, the definition of group companies now "includes such companies (other than promoters and subsidiaries) with which there were related party transactions, during the period for which financial information is disclosed (3 years) as covered under the applicable accounting standards and also other companies considered material by the board of the issuer." Further, from the draft regulations, it appears that the disclosure relating to group companies have been significantly reduced, with the disclosures related to litigation being completely scrubbed.

Though SEBI might have been late in addressing what has often been its problem child, the new regulations are promising in its assurance of well-defined and meaningful disclosure requirements. One can almost hear potential issuers, merchant banks, legal counsel and other deal-makers heave a collective, if cautious sigh of relief at a cherished vision of an IPO-road rent with one less fork in the regulatory road.

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