



Company Groups in India



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Foreword

The report presents an overview of company groups in India, including group structures (e.g. hierarchical structures and cross-shareholdings), promoters, and related party transactions. It also covers the legal and regulatory approaches to addressing issues relating to company groups.

The quantitative analysis of the report is primarily based on the Prowess dx dataset that covers financial data for over 40 000 listed and unlisted companies as well as data on shareholding patterns for over 5 000 listed companies. To prepare this report, Securities and Exchange Board of India (SEBI) and the OECD conducted a focused survey of selected listed companies that are part of company groups.

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Executive Summary

Like in many other advanced and emerging markets, company groups are prevalent in India. On average, Indian listed companies have more than tripled the number of subsidiaries for the past 15 years and as of March 2020, listed companies in the NIFTY 50 index have an average number of approximately 50 subsidiaries/step-down subsidiaries.

A company group can be structured in several ways. One way is a pyramidal structure or hierarchical structure. The pyramidal structure can help solve financing problems through inter-group transactions or credits. However, it has been argued that the discrepancy between cash-flow rights and voting rights created by pyramidal structures may give firms at *upper levels* incentives to extract private benefits at the expense of minority shareholders' interests. As of December 2020, out of the 100 largest listed companies by market capitalization, approximately 40 India listed companies had three or more layers of subsidiaries/step-down subsidiaries, surpassed by Singapore and Malaysia and followed by Thailand, Indonesia, and Viet Nam. Another possible structure is a cross-shareholding, where companies own each other's stock. Among the top 500 listed companies in terms of market capitalization, the number of listed companies having cross-shareholding relationships with other companies has been stable since 2013, ranging between 61 and 70.

To enhance oversight over expanded and complex groups structures, SEBI has strengthened its regulations. These measures include to revisit the definition of material subsidiary that requires enhanced monitoring, to strengthen the oversight function by the Audit Committee, and to mandate disclosures in respect of loans/guarantees/comfort letters/security provided by the listed entity directly or indirectly to promoter/ promoter group entities, directors, KMPs or any entity controlled by them. SEBI also issued the circular that recommends a listed entity with a large number of unlisted subsidiaries to monitor its governance through a dedicated group governance unit or governance committee comprising the board members.

Another important issue is the concentration of ownership by promoters. When it comes to ownership distribution in India, special attention should be given to promoters' tendency to act as a group. To focus on some largest promoters and interpret them in isolation does not provide a meaningful picture of ownership landscape. The average shareholdings by promoter groups/promoters have been stable for the largest 500 listed companies by market capitalisation since 2006. This is also the case for shareholdings by non-promoters, and the gap between shareholdings by the two types of shareholders as well as the level of ownership concentration has not changed materially. SEBI has introduced policy measures to ensure that independent directors are free from undue influence and play a critical role in protecting minority shareholders' interest. Those measures include strengthening provisions relating to the qualification of independent directors. In addition, SEBI has issued the Stewardship Code to promote stewardship activities by institutional investors. As of March 2020, the aggregate value of shareholdings by institutional investors is nearly 2.5 times as large as in 2007, surpassing the increase in shareholdings by all promoters including Indian corporate promoters and the government. Given a rapid growth in institutional investors' ownership and pressing need to monitor the board of directors and management, the Stewardship Code requires institutional investors to monitor and engage with investee companies in

matters including the company's strategy and performance, quality of leadership, corporate governance, ESG consideration, and shareholder rights. Further, SEBI has launched a review of the concept of "promoters" and is considering a shift to "person in control/controlling shareholders" given the changing ownership landscape.

Related party transactions are one of the central issues with respect to company groups. While abusive related party transactions harm minority shareholders' interests, intra-group transactions can also contribute to economic development under certain circumstances. Given the importance of company groups in the economy, related party transactions are prevalent in India. In 2006, approximately 5.5% of the total consolidated income originated from related party transactions, which has risen to 11% in 2019. SEBI has taken policy measure to address conflict of interests arising from related party transactions. Recent examples include strengthening disclosure provisions and expanding the scope of related party transactions that require approval by the Audit Committee.

With close attention to developments in the capital market and corporate governance practice, SEBI will continue to develop regulatory framework for corporate governance.

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1. Prevalence of company groups in India

Reasons for operating in company group structures

Corporate ownership through company groups is going up and is set to be a dominant pattern of shareholding in an important number of markets (OECD, 2020^[1]). This is so for India as well. On average, Indian listed companies have more than tripled the number of subsidiaries during the past 15 years and, as of March 2020, listed companies in the NIFTY 50 index have an average number of approximately 50 subsidiaries/step-down subsidiaries. Further, out of approximately 4 100 listed companies for whom data is readily available, there were 15 listed companies that have more than 100 subsidiaries including wholly-owned subsidiaries and step down subsidiaries, while a few of them had more than 200 subsidiaries.¹

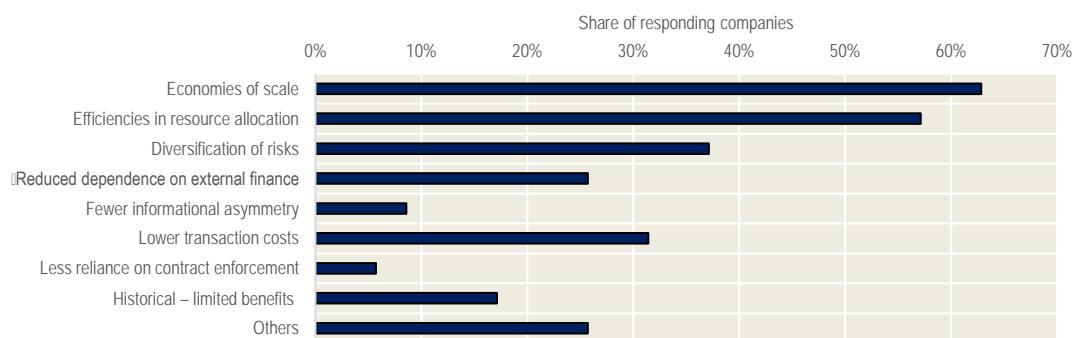
While a company can operate on a standalone basis, and in fact eight companies having no subsidiary are included in the top 100 listed companies by market capitalisation, there are several benefits of carrying out business activities through affiliated yet legally distinct companies. These benefits include economies of scale/scope, diversification of risks, creation of competitive advantages, efficiencies in resource allocation, centralised functions, less reliance on contract enforcement and easier access to internal capital. These advantages and benefits make company groups important contributors to the economy through employment generation and, in case of international company groups, cross-border transfer of technologies and talents.

In March 2021, SEBI and the OECD conducted a survey to better understand how Indian listed companies address issues relating to company groups. The survey focused on large listed companies having more than 10 subsidiaries. 41 out of 160 listed companies responded to the survey. According to the survey, the majority of the companies operate in company groups because of the benefits discussed above, with a few companies doing so for historical reasons (See Box 1.1). It is observed that economies of scale and efficiencies in resource allocation were the top two reasons for choosing to operate in a company group structure. In contrast, the responding companies did not consider less reliance on contract enforcement as a significant advantage (Figure 1.1).

¹ As of March 2020, there were 5052 listed companies on the BSE and NSE, 930 of which were suspended from trading.

Figure 1.1. Reasons for operating in company groups

This figure shows the main reasons why Indian listed companies operate in company group structures. The surveyed companies were asked to select one or more options. For instance, 63.9% of the participating companies consider economies of scale as one of the main reasons for operating in company groups.



Source: OECD-SEBI Survey on Company Groups

Box 1.1. Historical backgrounds for expansion of company groups

Until the early 1990's, in virtually all manufacturing, the government had a control over not only the product that a firm could produce but also the quantity and the location in which the factory could be set up. In addition, as part of the central planning, the government did not allow for unbridled expansion of capacity. It was therefore not unusual for a textile manufacturer to be given a license to produce cement. As industries were often protected through high tariffs, business houses started a new business line with a license even if there was no clear synergy between the existing business lines and the new one. Many of the older business houses have a large number of group companies, partly on account of past central planning by the government (Mohan, 2018^[2]).

Regulatory challenges

While there are compelling reasons for formation of a company group, complex company group structures raise a number of challenges for regulators. As evidenced by the survey, companies operate in a group structure to achieve efficiencies in resource allocation and economies of scale, but the costs of company groups may outweigh those benefits. Controlling ownership that can have influence over the entire group structure may result in misallocation of human, financial, and management resources. Without any good reason, cash flow generated by profitable group companies may be invested in unprofitable business within the same group (Kahna, 2002^[3]). In addition, some group firms may be used as conduit to siphon off funds to other group entities. Regulators have strengthened regulatory framework to bring more transparency to the company group structure and address conflicts of interest, but the more complex the structure of a group, the greater the potential for opacity of transactions and conflicts of interest between controlling and minority shareholders. Despite regulatory reforms made, the regulatory challenge still lies in managing the potential risks of abuse and ensuring the equitable treatment of shareholders.

Company group structure - pyramidal structure

A company group can be structured in several ways. One way is a pyramidal structure or hierarchical structure. In a simple pyramidal structure, a firm directly controls some firms, which in turn control other firms, which might control other firms, and so forth. The pyramidal structure helps solve financing problems through inter-group transactions or credits. However, there is a possibility that discrepancy between cash-flow rights and voting rights created by pyramidal structures may provide firms at 'upper levels' incentives to extract private benefits at the expense of minority shareholders' interests (Bebchuk, 2000^[3]). Figure 1.2 shows a simple form of a pyramidal structure.

Figure 1.2. Pyramidal structure of company groups

This shows a simple form of pyramidal structure of company groups

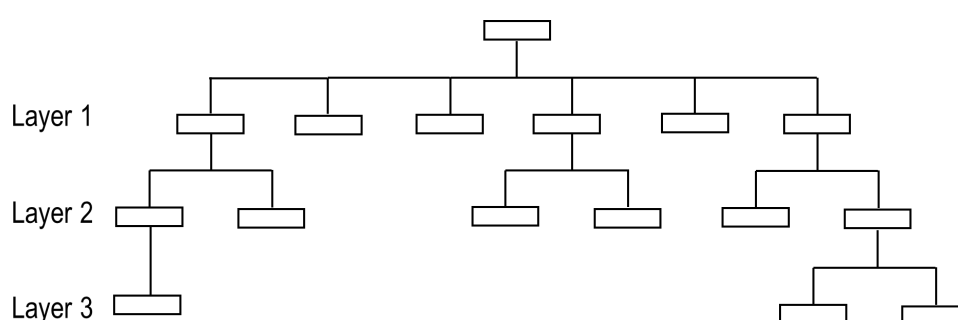


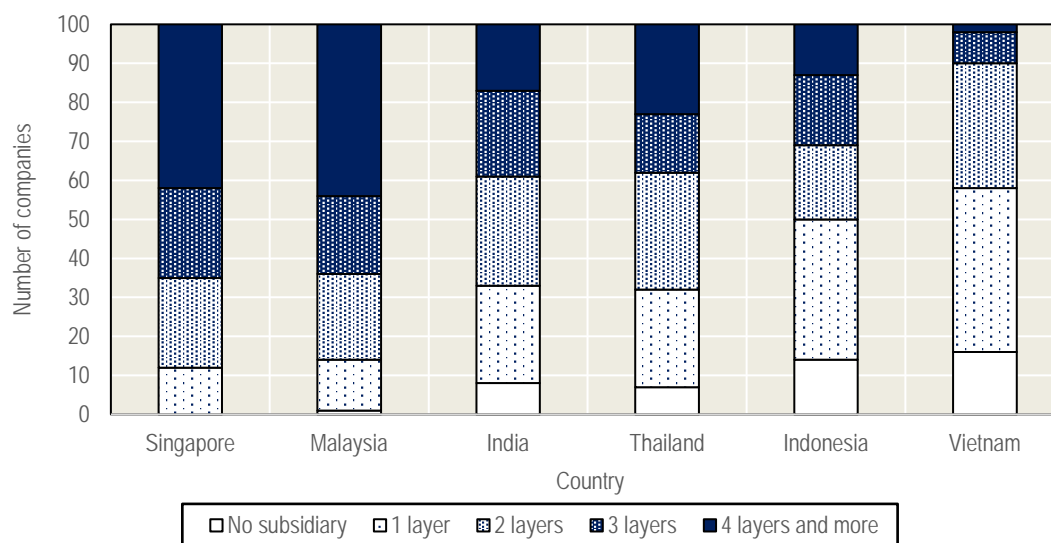
Figure 1.3 shows the number of layers for the top 100 listed companies in selected jurisdictions including Indonesia, Malaysia, Thailand, Singapore, and Viet Nam. As of December 2020, only eight Indian listed companies do not have a subsidiary, while approximately 40 India listed companies had three or more layers of subsidiaries, surpassed by Singapore and Malaysia and followed by Thailand, Indonesia, and Viet Nam. It should be noted, however, that those listed companies may be subsidiaries of other holding companies and there may be more layers upward.

In 2017, the India government introduced a limit on layering with an aim to prevent misuse of a complicated group structure that includes diversion of funds and money laundering (OECD, 2020^[1]). In principle, no company is allowed to have more than two layers of subsidiaries.

To count the number of layers of subsidiaries, one layer comprising of one or more wholly-owned subsidiaries shall not be taken into account. While the limitation was introduced with a view to protect the interest of the minority investor, such restriction is not a globally common regulatory approach with the notable exception of Israel, partly because it may substantially affect the business activity of company groups. To address this issue, a *grandfathering* provision was written into the regulation to allow the existing companies in India to continue with the existing structure, provided they will not add any additional layer of subsidiaries. Further, certain business sectors, such as banks, insurance, systemically important non-banking non-finance companies, and government-owned enterprises, are exempt from this restriction on layering. Nor does this restriction apply in the case of acquisition of a foreign entity having two or more layers.

Figure 1.3. Number of layers

This shows the number of layers for the top 100 listed companies in selected jurisdictions.



Note: This analysis covers the top 100 listed companies (by market capitalisation). To count the number of layers, the analysis does not exclude wholly-owned subsidiaries and does not include associates.

Source: Corporate disclosure, Thomson Reuters Refinitive, Prowessdx.

Cross-shareholding

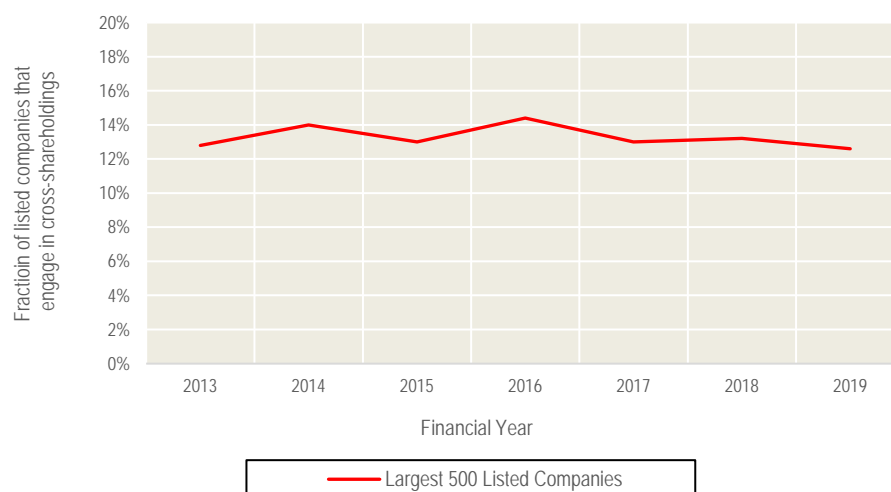
Another possible company group structure is a cross-shareholding, where companies own each other's stocks. It has been argued that cross-shareholdings may help to maintain business relationships and protect companies from a potential hostile takeover (OECD, 1999^[4]). From a perspective of corporate governance, however, cross-shareholdings often concern investors.

One important reason is that cross-shareholdings aimed at maintaining good business relationships result in voting in favour of the incumbent management and can insulate them from market pressures (Goto, 2014^[5]). Figure 1.4 displays the number of cross-shareholdings in India. In 2019, out of 500 listed companies, 63 companies are in crossholding relationships, most of which constitute part of a company group and have common promoters and at times common directors.

According to the SEBI-OECD survey, nearly 95% of surveyed companies which are in cross-shareholding relationships responded that they have been in cross ownership relationships for historical reasons. These companies do not see a clear benefit of the relationship. Nevertheless they responded that they will maintain the relationship despite the limited clear benefit.

Figure 1.4. Cross shareholdings

This figure shows the proportion of the top 500 listed companies that engage in cross-shareholdings. Since 2013, more than 61 listed companies have engaged in cross shareholding relationship with other listed companies.



Note: The analysis does not include a cross-shareholding relationship between an Indian company and a foreign company but covers cross-shareholding relationships between listed companies and unlisted companies.

Source: Prowessdx

In India, a listed company is not required to disclose its cross-shareholding relationships separately. As a consequence, the analysis above is based on disclosure about investment in the financial statements of the company and may not provide a fully accurate picture of cross-shareholding relationships in India. In some jurisdictions, however, the regulatory framework contains disclosure provisions relating to cross-shareholdings. For instance, in Japan, all listed companies are required to disclose detailed information about the cross-shareholdings, provide justification for maintaining each stock, and offer plans for unwinding them (Financial Services Agency of Japan, 2019^[6]). Specific disclosure provisions for cross-shareholdings may help shed more light on the scale and importance of cross-shareholdings in the Indian listed corporate sector.

Group governance

The expanded and complex company group structures have brought increased attention to group governance in India. As the Kotak Committee report mentioned, investors value the entire business structure despite having direct shareholding only in the listed holding company (Securities and Exchange Board of India, 2017^[7]). Ineffective group governance and lack of transparency in group structures may affect investors' confidence.

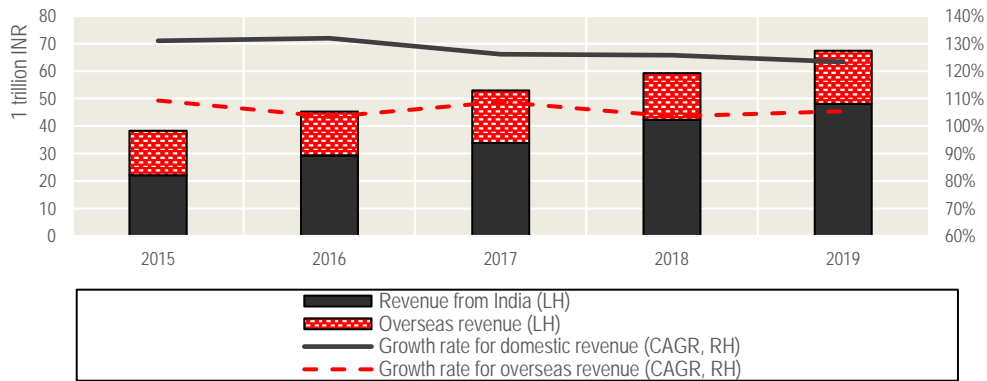
In this regard, SEBI LODR (Listing Obligation and Disclosure Requirements) Regulations impose specific obligations on a listed company having a "material subsidiary". For instance, at least one independent director of a listed company is required to serve as a director of an unlisted material subsidiary so that the parent company can effectively monitor its material unlisted subsidiaries. Previously this requirement was applicable only to domestic material subsidiaries, but Indian companies have obtained business opportunities in not only domestic markets but also foreign markets. As Figure 1.5 (Panel A) shows, the growth rate for domestic revenue has been kept at over 20%, beating the GDP growth rates ranging from 5% to 8% during the same period, while the growth rate for foreign revenues has been strong and kept at

about 5%. With the recognition that foreign subsidiaries are also an integral part of Indian company groups, India has extended its regulatory perimeter to foreign subsidiaries.

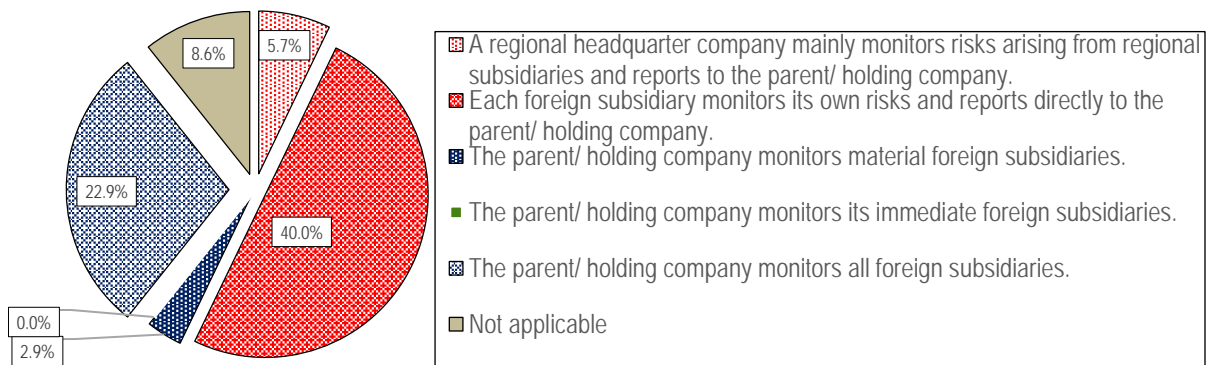
Figure 1.5. Revenue by geography and monitoring for foreign subsidiaries

Panel A shows revenue by geography while Panel B shows how group parent companies monitor risks arising from their foreign subsidiaries.

(Panel A)



(Panel B)



Note: Panel A covers all listed companies which disclose revenue by geography.
 Source: Prowesdx, OECD-SEBI Survey on Company Groups

Furthermore, with effect from April 2019, SEBI strengthened the threshold for a material subsidiary to enhance the monitoring. The revised SEBI LODR Regulations define a material subsidiary as ‘a subsidiary whose income or net worth exceeds ten per cent of the consolidated income or net worth respectively, of the listed entity and its subsidiaries’. In addition, the management of the unlisted subsidiary shall periodically inform the listed entity’s board of all significant transactions and arrangements entered into by the unlisted subsidiary. The minutes of the meetings of the board of the unlisted subsidiary are also required to be placed before the board of the listed entity. This reporting requirement is applicable to all unlisted subsidiaries whether incorporated in India or a foreign country. The Audit Committee of the listed entity is also required to review the utilisation of loans/advances/investments in its subsidiaries, which exceed INR 100 crores or 10% of the asset size of the subsidiary, whichever is lower. SEBI LODR Regulations do not go into detail as to how the group parent company is involved in the process of monitoring risks arising from foreign group companies. However, the top 1 000 listed companies are

required to constitute a Risk Management Committee. With this respect, according to the SEBI-OECD survey, in 40% of the responding companies, each foreign subsidiary monitors its own risks and directly reports to the parent/holding company, while in 5.7% of the responding companies a regional headquarter company monitors its regional subsidiaries and reports to the parent/holding company. In the rest of the companies, the risk is monitored by the parent/holding company (Panel B of Figure 1.5).

Another important development in the regulatory framework for company groups in India relates to the group-wide governance committee and group policy for corporate governance. In May 2018, SEBI published a circular with respect to group governance, based on the recommendations of the Kotak Committee report (Securities and Exchange Board of India, 2018^[8]). As per the circular, a listed company with a large number of unlisted subsidiaries may monitor its governance through a dedicated group governance unit or governance committee comprising the board members.² The circular recommends such a listed company to develop a strong and effective group governance policy. Although the circular leaves it at the discretion of the listed companies to set up a group governance committee or develop a group-wide policy, some Indian companies have proactively adopted those recommendations. In order to enhance transparency, SEBI vide Circular dated May 31, 2021 has also mandated disclosures in respect of loans/guarantees/comfort letters/security provided by the listed entity directly or indirectly to promoter/promoter group entities, directors, KMPs or any entity controlled by them. These disclosures shall form part of the Compliance Report on Corporate Governance and shall be reported on a half-yearly basis, with effect from FY 2021-22.

According to the SEBI-OECD survey, 12% of the responding companies said that they have a group governance board or committee. The number of subsidiaries that these companies with a group governance board/committee hold varies, ranging from 11 to 144, although the circular does not provide for the threshold of “a large number of unlisted subsidiaries”. The composition of the group governance committee also varies across companies. While a few companies have senior management of the group parent company in their group governance committee or unit, other companies constitute the committee as a body composed of independent directors only. From the findings of the survey, it is observed that the listed companies having a group governance committee or unit have not necessarily developed a group governance policy. Nearly 17% of the responding companies having group governance committee indicated that they also have a group governance policy. Most of those group governance policies cover financial, operational, compliance, sustainability, and cyber security risks.

² The circular does not clarify the threshold for “a large number of unlisted subsidiaries”.

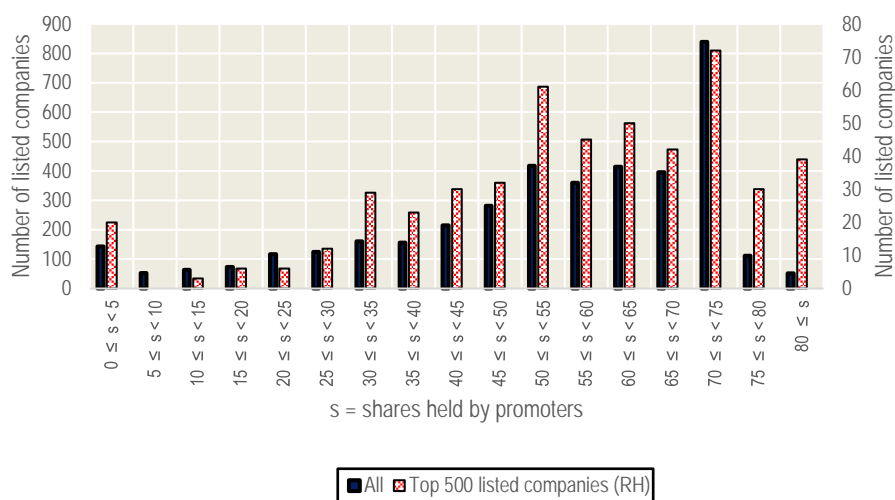
2. Ownership of company groups

Promoters in Indian listed companies

The ownership structure of listed companies in India can be characterised by promoters who in principle refer to controlling-shareholders or founders. Promoters may be an individual, their family members and associates, investment vehicles and corporate bodies including listed entities. Further, promoters may not necessarily have a significant portion of shareholding in the company. With a recognition that founders, or founder families can control the direction of a listed company even with small shareholding, the India regulatory perimeter extends to persons who may have a de facto 'control' over the company regardless of the proportion of their shareholding.³

Figure 2.1. Distribution of promoters and promoter groups

This figure shows distribution of shareholdings of promoters & promoter groups for the top 500 listed companies and all listed companies, as of March 2020.



Note: The analysis covers all companies that are listed on BSE and NSE but excludes suspended listed companies. The top 500 listed companies are selected by market capitalisation as of March 2020.

Source: Prowessdx

³ Companies Act, 2013 (Sub-Clause (69) of Clause (2)), defines a promoter as a person - (a) who has been named as such in a prospectus or is identified by the company in the annual return; or (b) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or (c) in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act. SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 also contain a similar definition of 'promoter'. In many instances, controlling shareholders are considered as promoters. See "Consultative Paper on Review of Corporate Governance Norms in India" (2013), SEBI

Figure 2.1 shows the number of listed companies having different levels of shares held by promoters and promoter groups. While the distribution of shareholding of promoter and promoter group is skewed to the left with a peak at 70-75% for both all listed companies and the top 500 listed companies, some companies have promoters with smaller shareholdings. In any case, listed entities are required to maintain a minimum public shareholding of 25%, subject to certain conditions. In India, all listed companies are required to disclose ownership patterns by each promoter and promoter group without any threshold. The importance and relevance of this regulation in India is demonstrated by the fact that as of March 2020, in the largest 500 listed companies by market capitalisation, 485 companies disclose detailed ownership patterns by promoters⁴ and approximately 210 companies disclose a promoter's shareholding which is less than 0.05%. Those persons or groups who have a de-facto control with small shareholdings cannot be captured by a simple dichotomy between controlling shareholders and non-controlling shareholders, and India's experience in addressing this issue can be beneficial to other economies, where a founder or their family members have an influence over the listed company but do not necessarily have a significant fraction of the equity shares. Indeed, family business has played an important role in economic development of the Asian region. With this respect, in Singapore, a Family Stewardship Code was introduced in 2018. The Family Stewardship Code, composed of seven principles, is designed to encourage owners of family business to act as a good steward (Stewardship Asia, 2020^[9]). In a different context, Japan published in 2020 an interim report on a framework for protecting minority shareholders of a listed company with shareholders having de facto controls over the company. Together with those initiatives, India provides a good example of policy measures. In particular, India's regulatory framework is unique in that it has comprehensive disclosure provisions that cover shareholding pattern with detailed breakdown of promoters, including promoters in control with no shareholding, and non-promoters.

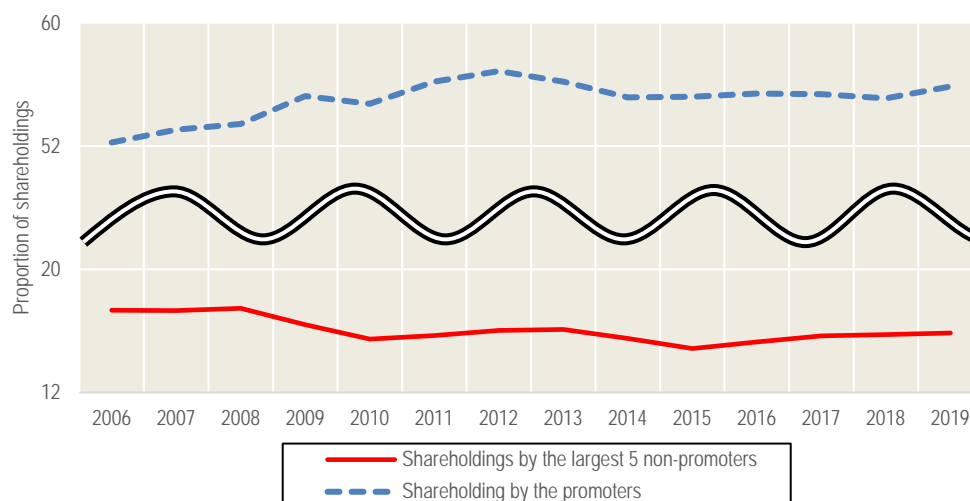
Concentration of ownership

An important development with respect to promoters is the concentration of ownership. Such concentrated ownership is a common feature in many advanced and emerging markets. There is, however, a significant variance with respect to the dominant category of owners. In the United States and Europe, the largest category of owners is institutional investors. This trend is less pronounced in Asian markets. When it comes to ownership distribution in India, special attention should be given to promoters' tendency to act as a group. To focus on some largest promoters and interpret them in isolation does not provide a meaningful picture of the ownership landscape. Figure 2.2 shows that shareholdings by promoter groups/promoters have been stable for the largest 500 listed companies by market capitalisation since 2006. This is also the case for shareholdings by non-promoters, and the gap between shareholdings by the two types of shareholders as well as the level of ownership concentration has not changed materially.

⁴ The balance 15 companies did not have an identified promoter. These are professionally managed and institutionally owned.

Figure 2.2. Ownership concentration by promoters and non-promoters

This figure shows the average shareholding by all promoters as well as the largest 5 non-promoters for the largest 500 listed companies by market capitalisation.



Note: The analysis covers the 500 largest listed companies.

Source: Prowessdx

From a perspective of corporate governance, the concentration of ownership in the hands of promoters in parallel with the diffusion of ownership by non-promoters can give rise to conflict of interest between promoters and minority shareholders. For example, promoters may have an incentive to borrow funds from the listed company at a lower interest rate while minority shareholders expect the company to lend the money at a higher rate. Furthermore, the risk profile and the rate at which money is lent may not be correlated. Another example is that in restructuring a company group, promoters may have an incentive to sell-off assets of the listed company or transfer assets to another group company at a lower cost while minority shareholders expect the listed company to offer a reasonable price for the asset. Despite these problems, minority shareholders may not have an effective means to voice their concerns or not have a strong incentive to correct the distortion. There are regulatory mechanisms to address such concerns such as disclosure of related party transactions, prior approval of audit committee for such transactions, and shareholder approval in cases of transactions above a threshold. Potential conflicts of interest, however, persist.

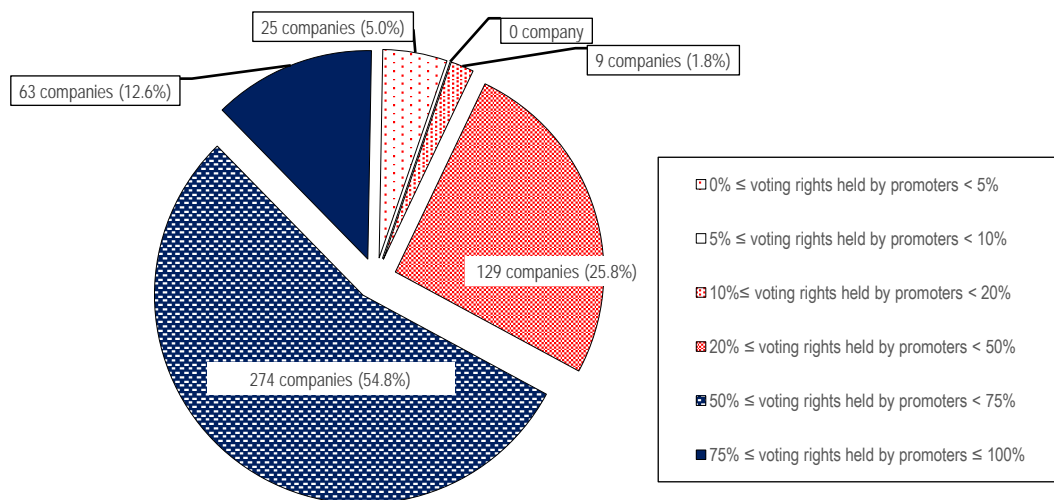
In this context, regulators see independent directors as playing a critical role in addressing conflicts of interest and preventing the corporate promoter from extracting undue private benefits at the expense of minority shareholders' interest. With that recognition, the LODR prohibits a promoter, a relative of a promoter, and any person related to a promoter from being an independent director. Further, SEBI LODR require that at least half of the board of directors shall be independent directors for listed companies having an executive director as the board chairperson, and at least one-third of the board of directors shall be independent directors for companies having a non-executive director as the chairperson.

In addition, the nomination process of directors matters. As shown in Figure 2.3, promoters and promoter groups have the majority of voting rights (i.e. more than 50%) in nearly 70% of the largest 500 listed companies in India. As promoters and promoter groups often take concerted actions, this may have significant implications for corporate governance. Promoters with significant shareholdings may exercise their control through the selection of directors, and the transparency and integrity of the board selection is

essential, especially for independent directors, to protect minority shareholders' interest. This is why Indian regulatory framework has paid close attention to selection process of directors.

Figure 2.3. Distribution of voting rights by promoters

This figure shows distribution of non-banking companies whose promoters have different levels of voting rights, as of December 2020.



Note: The analysis covers the 500 largest listed companies by market capitalisation. No company falls under the category ranging between 5% and 10%.

Source: Corporate disclosure, Bombay Stock Exchange

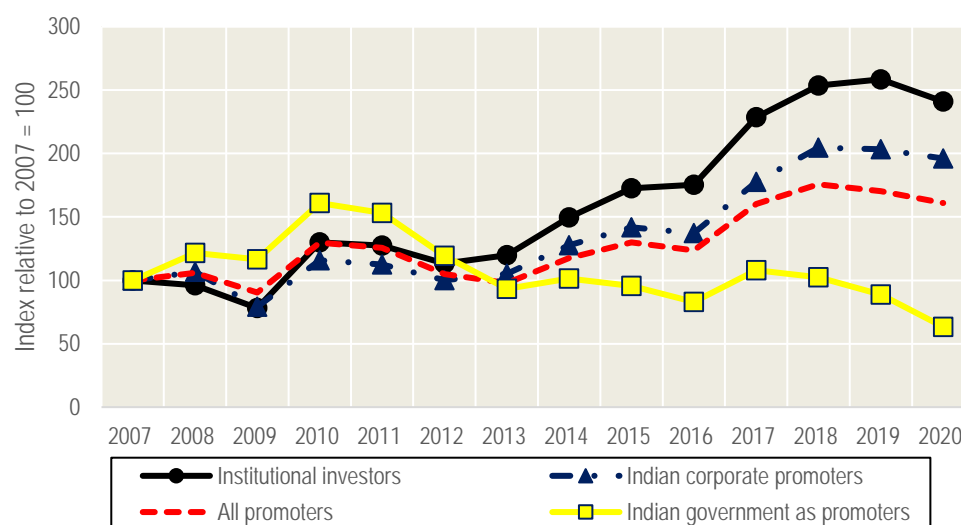
To ensure that independent directors are free from undue pressure, SEBI also has strengthened the appointment and removal process of independent directors, effective from January 01, 2022. Under the new regulation, both appointment and removal of independent directors will be through special resolution of shareholders. In addition, the independence of the nomination and remuneration committee has been enhanced with two-thirds of its members to be independent directors. The provisions relating to disclosure for the nomination process have also been strengthened, with the requirement to disclose the skills and capabilities required for the appointment of the independent directors and how the proposed individuals meet the requirement of the role.

Further, SEBI has taken policy measures to promote stewardship activities by institutional investors. Figure 2.4 presents the aggregate value of shareholdings by different types of shareholders. As shown, institutional investors have significantly increased their shareholdings for the top 500 listed companies, and as of March 2020, the aggregate value is nearly 2.5 times as large as in 2007, surpassing the increase in shareholdings by all. While institutional investors, in particular index funds, give households easier access to capital markets, their engagement activities have an increasingly important implication for corporate governance of investee companies. This is especially the case in India, where there is a pressing need to monitor the board of directors and management (Securities and Exchange Board of India, 2021_[10]). Unlike similar initiatives in other Asian jurisdictions, India's Stewardship Code, composed of six principles, are a mandatory requirement that mutual funds and other alternative investment funds (hereinafter referred to as institutional investors) shall follow. Under the code, institutional investors are required to monitor and engage with investee companies in matters including the company's strategy and performance, quality of leadership, corporate governance, ESG consideration, and shareholder rights. The code also requires institutional investors to formulate a clear policy for collaboration with other institutional

investors, where required. Further, they need to have a clear policy on voting and disclosure of voting activities and are expected to vote on all their shares i.e. they cannot abstain (Securities and Exchange Board of India, 2021^[11]). As institutional investors are still collectively minority shareholders but their average shareholdings have reached to approximately 25% for the top 500 listed companies in 2020, these requirement can serve as an effective mechanism to protect minority shareholders' interest in some important matters including appointment of independent directors.

Figure 2.4. Growth/decline in ownership of different categories of investors in terms of market value (relative to 2007)

This figure shows changes in the aggregate market value of shareholdings by all promoters, institutional investors, Indian corporate promoters, and the government as a promoter for the top 500 listed companies.



Note: Institutional investors mean mutual funds, banks, venture capital funds, insurance companies, and qualified foreign institutional investors.
Source: Prowess

Lastly, in the broader context of corporate governance, SEBI has launched a review of the concept of “promoter”. Together with a significant growth in the shareholding by institutional investors, a rise in new age and tech companies which are non-family-owned businesses or do not have an identifiable promoter group indicates that the ownership landscape is transforming. Even in cases where a promoter group exists, the concentration of ownership and controlling rights do not vest completely with them. Further, there is increasing focus on better corporate governance with responsibilities and liabilities shifting to the board of directors and management, rather than promoters. These developments points to a need for revisiting the concept of “promoters” and regulatory approach to them. Even though persons who fall under “promoters” may not have controlling stakes any longer, treating them as promoters may give a disproportionate power. In May 2021, a consultation paper on review of the regulatory framework of promoter, promoter group, and group companies was published. SEBI Board has agreed in principle on the proposal of shifting from the concept of promoter to ‘persons in control’ or ‘controlling shareholders’. To achieve the objective in a smooth, progressive and holistic manner, SEBI shall engage with other regulators to ascertain and resolve regulatory hurdles, if any, and develop a roadmap for implementation of the proposed transition (Securities and Exchange Board of India, 2021^[13]).

3. Company groups and related party transactions

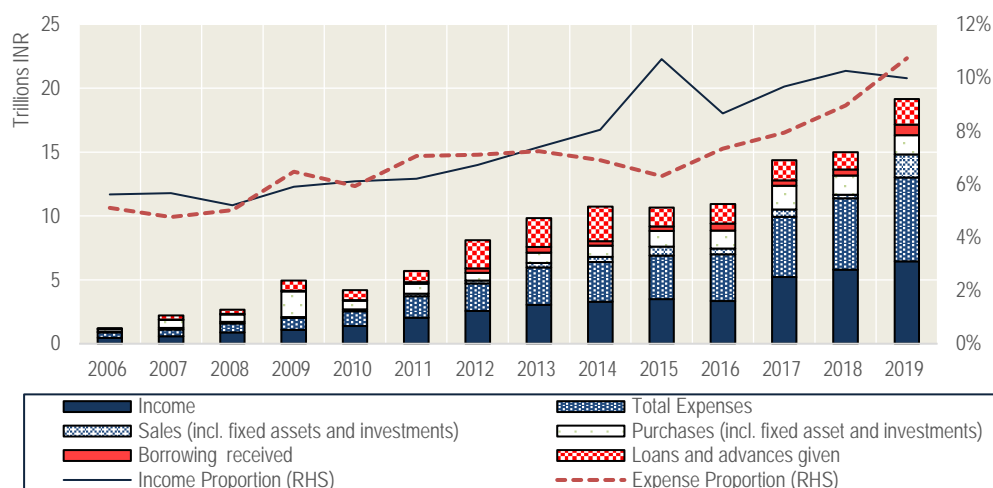
Increasing related party transactions

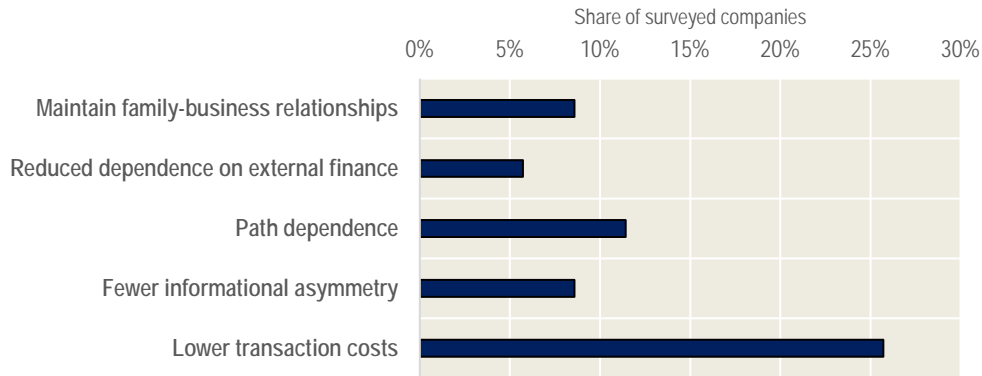
Related party transactions (RPTs) are one of the central issues relating to company groups. While there are cases where abusive related party transactions harm minority shareholders' interests, intra-group transactions can contribute to economic development under certain circumstances (See also Box 3.1). For example, it is often pointed out that related party transactions are important to overcome contracting problems in jurisdictions, where judicial or other legal institutions are weak (Dammann, 2019^[14]). In India, almost all the companies have related party transactions but they also disclose the transactions in the annual report. Panel A of Figure 3.1 shows that related party transactions have played a significant role in company groups. In 2006, approximately 5.5% of the total income came from related party transactions. This proportion has risen to 11.0% in 2019.

Figure 3.1. Related party transactions

Panel A shows the total amount of related party transactions for the top 500 listed companies and its breakdown. It also presents the average proportion of income and expenses arising from related party transactions over the total income and expenses. Panel B is based on the OECD-SEBI Survey and shows the main reasons that the surveyed India companies are engaged in related party transactions.

(Panel A)



(Panel B)

Note: Panel A covers top 500 listed companies. For the proportion of income and expenses, the denominator is based on the stand-alone financial statement.

Source: Prowessdx, OECD-SEBI Survey on Company Groups.

To address conflicts of interest arising from related party transactions, SEBI has strengthened relevant regulations. In 2019, SEBI constituted a Working Group, with an aim to review and strengthen the regulatory norms pertaining to related party transactions undertaken by listed entities. Considering recommendations by the Working Group, SEBI has tightened the norms by expanding the scope of related parties to include all persons/entities that are part of a promoter or promoter group irrespective of their shareholding. Further, any person or entity that holds, directly or on a beneficial interest basis, over a certain threshold shall also be considered as related parties. The threshold is set to be 20% from April 1, 2022, and to be elevated to 10% from April 1, 2023.

The ambit of related party transactions has also been expanded to cover transactions with unrelated parties in case the ultimate beneficiary of the transaction is a related party of the listed entity/subsidiaries. Further, related party transactions shall be approved only by independent directors on the Audit Committee.

In addition, it was pointed out that the current RPT framework may be insufficient to cover transactions where the listed entity may transfer its assets/value to a subsidiary in India or overseas and such entity in turn transacts with related parties of the listed entity to move the assets out of the consolidated entity (See also Box 3.2). To address the issue of siphoning money through unlisted subsidiaries, the prior approval of the audit committee of the listed entity shall be required subject to thresholds as specified by SEBI, where its subsidiary is a party but the listed entity is not a party to a transaction. Disclosure requirements are also being strengthened by prescribing minimum information which shall be available to stakeholders.⁵

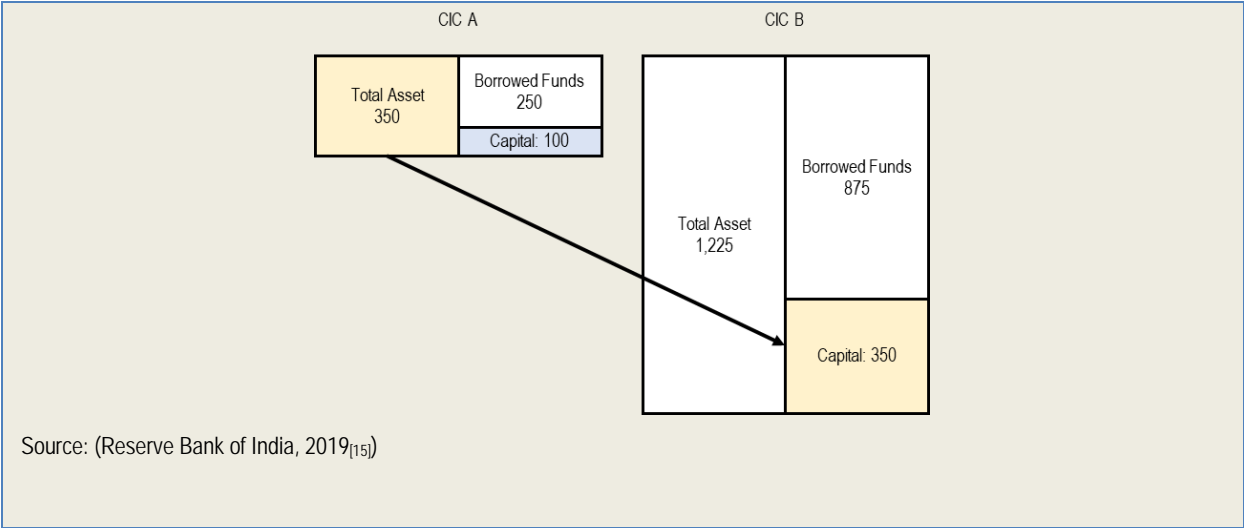
⁵ For more details, see (Securities and Exchange Board of India, 2020_[18]).

Box 3.1. Brand royalty fees

As businesses operate across geographies, they often face a challenge on how to forge its identity and how to ensure flexibility of operation. Now royalty payment is a common practice for companies operating under the umbrella of the global brand. Those companies make payment towards royalty/ brand usage – either for technology or brand or some intangible service that the parent company may provide. Royalty payments are recognized as there is value in brand strength and product technology. While royalty is a legitimate expense, some multi-national company groups of India have taken advantage of the new liberalised regime and may pay the disproportionate amount as the royalty. It is estimated that the five highest royalty paying companies had remitted about INR 13.1 billion in 2010 and the same has increased exponentially to INR 55.7 billion by 2020 (an estimate based on Ace Equity). Given the growing role of royalty payment, it is important that a company makes better disclosure on the value the company derives from a brand or technology for which it has agreed to pay royalty, brand, or technical fees, and such royalty payments shall be classified as related party transactions. Currently, a transaction involving payments made to a related party with respect to brand usage or royalty is considered material and requires approval of shareholders, if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceed five per cent of the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity.

Box 3.2. Complex group structure and related party transactions

While India has taken measures to address conflicts of interest arising from related party transactions, it could be the case that a complex group structure may make it easier for constituent companies to circumvent regulatory provisions. Abuse of such structure was recently witnessed in the case of an unlisted Core Investment Company (CIC) which is a company focusing on financing other companies within the group. Given that the CICs were expected to have exposure only to group companies through equity, debt or loans, the CICs were exempted from strict capital requirements that are applied to Non-Banking Financial Companies. This exemption, in combination with absence of restrictions on the number of CICs within the group, allowed for multiple gearing and excessive leveraging. As illustrated by the figure below, a CIC could borrow up to 2.5 times of its capital to invest in the capital of another CIC within the group. With more CICs, this excessive leverage could exponentially increase. To address these issues, the Reserve Bank of India recently revised guidelines for Core Investment Companies. The revision includes i) deducting the capital contribution of the CIC to another CIC to the extent such amount exceeds ten percent of the own fund when computing the adjusted net worth; ii) prohibiting a company group from having more than two layers of CICs; and iii) requiring the parent CIC in the group to constitute a Group Risk Management Committee which has the responsibility to monitor material risks, identify potential intra-group conflicts of interest, and ensure that the group has an effective internal control system in place.



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