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CORPORATE GOVERNANCE AND CONCENTRATED OWNERSHIP

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Abstract

Corporate governance and concentrated ownership are two pillars in shaping the structure and operations of businesses. Corporate governance refers to the system of rules, practices, and processes by which a company is directed and controlled. On the other hand, concentrated ownership refers to a situation in which a significant portion of a company's shares is owned by a small number of shareholders or a single entity. The interplay between corporate governance and concentrated ownership has significant implications for how companies are managed and governed. The relationship between corporate governance and concentrated ownership is complex and requires careful consideration. While concentrated ownership can bring benefits such as rapid decision-making and strategic focus, it also poses risks related to accountability and conflicts of interest. Effective corporate governance mechanisms are essential to address these risks and ensure that companies operate in the best interests of all stakeholders. By promoting transparency, accountability, and ethical behaviour, companies can build trust with shareholders and contribute to long-term value creation.

Key Words: Corporate Governance, Concentrated Ownership, Companies Act, Promoters.

Introduction

There is a wide range of national systems and organisations for corporate governance. Worldwide, there are two main types of corporate governance systems. One type is known as "the outsider system," which is prevalent in countries like the United States and the United Kingdom and is marked by widely distributed ownership. The other type is known as "the insider system," which is prevalent in countries like Japan and continental Europe and is marked by concentrated ownership or control. The role of firm ownership in corporate governance is growing in importance. Poor shareholder monitoring is a common problem with dispersed ownership, leading to insufficient shareholding control. Small shareholders

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probably will not care about monitoring since they would have to pay for it all and just get a tiny cut of the profits. Therefore, there would be zero oversight of the managerial team's work.

On the contrary, when one or a small number of shareholders possess a disproportionately large number of shares in a corporation, this is known as concentrated ownership. In a system of concentrated ownership, a small number of powerful shareholders can dictate major business decisions. One possible outcome of high levels of ownership concentration is the consolidation of power into the hands of a small number of people. To ensure openness, accountability, and the safeguarding of minority shareholders' interests—and to reduce the dangers linked with concentrated ownership—strong corporate governance processes are essential. When a company's ownership is highly concentrated, a handful of powerful shareholders can dictate the company's future course of action. A few individuals may end up with all the power and make all the choices if this happens. Faster decision-making and more responsiveness to changes in the market could result from this, but there would be problems with openness and accountability. Reducing the dangers associated with concentrated ownership requires the implementation of robust corporate governance systems. Their goal is to make sure that everyone's voice is heard when making decisions, whether that's minority shareholders, employees, customers, or society at large. Integrity, openness, responsibility, and autonomy of the board are cornerstones of good corporate governance. Particularly relevant in a situation of concentrated ownership are the board of directors' independence and composition. An impartial third party, an independent director, can assist keep shareholders' interests in check. The oversight of management, evaluation of strategic decisions, and protection of minority shareholder interests are all greatly influenced by them. To keep shareholders well-informed about the company's performance and dangers, it is crucial to be transparent in decision-making and financial reporting. Moreover, corporations with concentrated ownership are more likely to experience conflicts of interest, which can be lessened by good corporate governance measures. Concerns over related-party transactions or self-dealing by controlling shareholders to the detriment of minority shareholders are one example.

The rights of all shareholders can be better protected and conflicts like these can be lessened with strong governance frameworks that have transparent disclosure requirements and internal controls. While there are advantages to concentrated ownership, such streamlined decision-making and laser-like focus on strategy, there are also drawbacks, like accountability issues and potential conflicts of interest. Addressing these risks and ensuring that organisations function in the best interest of all stakeholders requires effective corporate governance processes. A lack of diversity of opinion and an increase in the possibility

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of abuse of power are two negative outcomes that may result from concentrated ownership, even though it may cause strategic focus and faster decision-making.

As a result, the problems with concentrated ownership may persist even after corporate governance procedures are in place. Companies may earn the trust of their shareholders and help create wealth in the long run by encouraging ethical behaviour, transparency, and accountability. Strong corporate governance can reduce risks, but it might not be enough to stop concentrated ownership from abusing its position. Even with rigorous governance procedures in place, problems like regulatory capture or board manipulation can arise. Further yet, if shareholders are the only ones considered, other stakeholders like employees and the community may have their concerns ignored. With well-defined standards in place, such as including stakeholders in decision-making processes, Companies can promote responsible and sustainable practices by establishing bodies and procedures for frequent stakeholder engagements, which will help prioritise the interests of all stakeholders. Furthermore, by offering multiple viewpoints and assuring supervision, a diverse and independent board of directors can assist in reducing the dangers linked to concentrated ownership. To ensure long-term sustainability and competitiveness, it is crucial for organisations to regularly examine and update their governance procedures. This will allow them to be agile and responsive to changing market conditions and stakeholder expectations.

Factors leading to Concentrated ownership

Concentrated ownership, particularly when held by business families, offers advantages such as strong entrepreneurial motivation and a sustained dedication to company long term success. Nevertheless, it can also present significant prospects for self-interested actions and various methos of diverting resources in favour of majority shareholders, to the disadvantage of minority shareholders. The regulatory issues lies in effectively balancing the advantages and disadvantages in a manner that can instil market trust, approval, and recognition.

Promoter control, often known as concentrated ownership, is prevalent in India. The following are the factors that contributed to this phenomenon:

I. Legacy Factor

During the early 19th century, several significant structural modifications were made that established the groundwork for the widespread growth and expansion of the concentrated ownership in India.The company granted licences to agency houses to conduct autonomous trade and other commercial operations. This led to the development of the system of administering agencies, which

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can be considered distinctively characteristic of India. Initially under British ownership, managing agencies played a crucial role in promoting, operating, and controlling business companies. The managing agency system held a position of dominance in India for almost a century, encompassing a wide array of firms, sectors, and geographical areas. However, as the dominating families entered their second and third generations, the system became corrupted because of interconnected ownership and directorates, intercorporate investments and loans, diversion of cash through commissions, and other unpleasant behaviours.As a result, there was strict legislative oversight and the management agencies eventually came to an end, as started by the Companies Act, 1956. The shift from the era of managing agencies to a home, ethnocentric, conglomerate culture occurred seamlessly. British managing agency had established strong and collaborative partnerships with numerous Indian business families over a significant period.

II. Patronage Factor

Several prominent Indian entrepreneurs, including Ghanshyam Das Birla, Jamnalal Bajaj, and Ambalal Sarabhai, had established strong connections with Mahatma Gandhi and the political leadership throughout India's fight for independence from British colonial control. After India gained independence, the ties that had been established among the national leaders, except for Gandhi who never held any position of state power, had a significant influence in influencing the country's industrial and developmental policies. Consequently, establishing connections with politicians and bureaucrats became a fundamental skill to guarantee commercial prosperity. This, in turn, made these business families appealing collaborators for foreign firms seeking to penetrate the Indian market.

Undoubtedly, patronage was not a completely unusual occurrence after independence.

The Tatas had previously derived benefit from their support of the British, who showed preference towards the anglicised Parsi community by granting them government contracts and assistance.

III. Institutional Factor

Furthermore, it has been argued that the absence of venture capital institutions and well-established capital markets in India has played a crucial role in promoting and maintaining concentrated ownership of Indian enterprises. An illustration of this is the Tata group's exploration into diverse new commercial endeavours. From 1870 to 2001, the group expanded into various industries including textiles, hospitality, steel, power, cement, soaps and toiletries, printing and publishing, aviation, chemicals, consumer electronics, commercial vehicles and locomotives. Although these firms vary greatly, the group has consistently achieved a top position in most of the industries it has

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entered. In nearly all these diverse developments, affiliated companies with financial capacity have played a role in supporting the growth.

Furthermore, during periods of institutional instability, dominating families and groups potentially aided the entrepreneurial ambitions of their own relatives by offering them financial, moral, and business assistance. Numerous modern business empires can attribute their establishment and expansion to the early assistance provided by influential families and groups.

Policies leading to Dominant Ownership

Certain policies also unexpectedly contributed to concentrated ownership in India. Several well-meaning policy and regulatory measures, aimed at rapid industrialization and development, in practice had the collateral affect of promoting and preserving concentrated ownership and control.

1. Capital Market development and Control

   One important change to the Indian capital market in the 1970s was the giant growth of the country's stock markets. One major factor propelling this growth was the Foreign Exchange Regulation Act, 1973 (FERA), which mandated that all firms controlled or owned by foreigners. Foreign ownership of more than 40% of the equity capital of noncore enterprises (which comprised most foreign corporations) was strictly prohibited by the FERA, a notable regulatory reform.The Controller of Capital Issues, an authority under the Union Ministry of Finance, was to decide on valuations for issuing fresh capital or selling their "excess" shareholdings to local Indian investors to dilute ownership. The second law that encouraged concentrated ownership was the policy towards partnerships and joint ventures between multinational corporations. Given that foreign ownership was typically limited to 40%, and that being a minority shareholder with the Indian partner retaining 60% was not always an option that was acceptable, a compromise formula was developed. Indian and foreign partners each received 40% of the total shares under this structure, with external minority shareholders acquiring the remaining 20% through a public offering.

2. Defence of Corporations

   An additional policy effort taken by the government, which had the implicit objective of shielding incumbent Indian management, particularly those who were connected to the political authorities of the moment, against the possibility of takeovers by foreign investors, further strengthened the institution of concentrated ownership. This was typically accomplished through the voting support of the financial institutions owned by the government that held block shares in the firms in

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question.

To assist incumbent or other desired managements in retaining or acquiring control of their assisted corporations, these government-owned institutions collaborated with one another, even holding regular inter-institutional meetings to decide investments and other matters, such as voting on important resolutions at company meetings. This was done to improve the situation.

The Pros and Cons of Promoter Control

Many view controlling investors as "opportunistic actors who seek to reap private benefits at the expense of minority shareholders," and they believe that concentrated ownership and control hurts the interests of noncontrolling shareholders. Nonetheless, concentrated ownership has endured globally since it benefits both controlling and non-controlling shareholders.Along with other minority shareholders, the government can likewise benefit from concentrated ownership. The government has been observed using the mechanism to advance policy goals of development and growth while also using it to extract rent for political and party purposes.

- Enhanced concentration on the performance of the entity.

Individual directly benefits from increased performance and is equally affected by poor performance, an individual businessperson, a managing owner, or a partner is likely to be more rigorous and devoted in running operations to maximise profits. This is because improved performance is directly beneficial to the individual. In contrast to professionally managed businesses, where the direct negative impact on the managers cannot be personally felt or experienced, this kind of entrepreneurial drive leads to painstaking attention to detail and strict monitoring over any undesirable wastages and leakages. This contrasts with the situation in which the businesses are handled by professionals. In the context of the worldwide financial crisis that occurred between 2007 and 2008, companies that had significant shareholders did not face lower stock returns in comparison to those that had substantial institutional block holdings. This is an illustration of how companies with significant shareholders handled high-risk operations with prudence and care. This is in stark contrast to the behaviour of companies with diversified ownership, which consequently depended on executive management.

There is a substantial body of data that demonstrates that there is a positive association between concentrated ownership and company performance on a global scale. Additionally, according to the findings of some studies, family-owned businesses "may outperform nonfamily businesses" at least until the next generation of family ownership takes over.

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The ownership of the promoter typically results in a more stringent control over costs, as well as an increase in revenues and an overall improvement in profitability.

- Credibility backs ventures that take risks and are innovative.

There is also the favourable reputation of establishing in-house venture capitalism and incubatory assistance, which has successfully produced new and often hazardous business initiatives that have matured into viable businesses over the course of time. Concentrated ownership also benefits from this positive reputation. The absence of specialised financial intermediaries to meet such requirements has been attributed to the fact that it has been credited with filling the hole in the system. In addition to providing a reputational platform, promoter control also gives the wherewithal in terms of financial, managerial, and risk-tolerance capacities that would be difficult for stand-alone entrepreneurs to bring together. To a large extent, the expansion and diversification of home-grown business groups in India over the course of the past century and a half may be credited to the parental advantage supplied by the promoters. Some examples of these groups include the Tatas, Birla's.

- **The Cons of Concentrated Ownership**

There are several drawbacks to concentrated ownership that must be considered alongside its advantages. These include, but are not limited to, increased potential for related party transactions, the exploitation of private benefits of control, and the expropriation of corporate opportunities. More stringent investor protection laws may limit the possibility of such projects. There must be further action in India to safeguard investors, even though such procedures have been tightened in recent years. Meanwhile, unscrupulous corporate actors in India can still take advantage of Indian investors, just as they can in other developing economies.

- Opportunities within the corporate sector.

One advantage of business group promoters is their ability to freely take advantage of appealing corporate possibilities from one entity within the group and transfer them to another entity where the financial rewards are more advantageous. This can also be applied in the opposite direction, where unprofitable business endeavours are transferred to entities with lower ownership rights to the cash flow generated by the business. When directors serve on many boards of competing corporations, it is likely that their decisions would be biassed towards the entities that offer them greater financial benefits. Commonly referred to as a "parenting advantage" in the realm of business and strategic policy, such decisions present the promoters with the opportunity to redirect potential business revenues from their rightful destination

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to a location that maximises the promoters' benefits. Furthermore, it has been noted that numerous business conglomerates have strategically elevated a group of unlisted satellite companies or affiliates to enhance the internal flow of funds and consolidate control rights for the promoters. This typically occurs within the context of legal regulations, frequently without providing any disclosures or attracting unwanted attention from other parties.

- Tunnelling

Tunnelling refers to an unlawful corporate practice where a majority shareholder or a high-ranking company insider diverts firm assets or prospective business opportunities for their own personal benefit. Tunnelling refers to many actions, such as exorbitant CEO compensation, dilutive share measures, asset sales, and personal loan guarantees, that can be categorised as such. The primary concern is the potential harm to minority shareholders, whose ownership is diminished or devalued due to improper acts that negatively impact the overall value of the business and consequently the value of the shares held by the minority shareholders. Investors in emerging economies have a heightened risk, as government and regulatory regulations in these markets may be inadequate to prevent this activity. This frequently occurs under the pretext of legality. The practice is not limited to moderately advanced economies; numerous examples may be observed in advanced economies, particularly those operating under "civil law" systems.

Conclusion

- Ownership and control by promoters, without the negative consequences that come along with it, can be of immense advantage to minority shareholders. The inherent agency potential for expropriation is nearly impossible to eliminate entirely; however, it may be worthwhile to attempt, through legislation and regulation, a regime of control and disclosure that would discourage expropriation by promoter shareholders and insiders controlling the company's operations.

- The empowerment of independent directors on boards and the disenfranchisement of interested shareholders at members' meetings are two major areas of laws that could be beneficial in accomplishing this purpose. These two recommendations have been implemented into the Companies Act, 2013 (often known as the Act), which is a piece of legislation that sets rigorous compliance obligations about certain transactions Ownership and control by promoters, without the negative consequences that come along with it, can be of immense advantage to minority shareholders. The inherent agency potential for expropriation is nearly impossible to eliminate

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entirely; however, it may be worthwhile to attempt, through legislation and regulation, a regime of control and disclosure that would discourage expropriation by promoter shareholders and insiders controlling the company's operations. This would be a step in the right direction. The empowerment of independent directors on boards and the disenfranchisement of interested shareholders at members' meetings are two major areas of laws that could be beneficial in accomplishing this purpose.These two recommendations have been implemented into the Companies Act, 2013 (often known as the Act), which is a piece of legislation that sets rigorous compliance obligations about certain transactions between related parties. Furthermore, the Companies Act contributed to further establishing India's corporate law approach as one that is focused on the interests of stakeholders. The Act included the codification of directors' duties to act in good faith to promote the interests of shareholders and other stakeholders; the duties of independent directors to safeguard the interests of all stakeholders, particularly minority shareholders; and a new requirement for companies to participate in corporate social responsibility.

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