# Enhancing Corporate Democracy through Larger Public Holding

**C.K.G.Nair**
*Director (Primary Market)*
*Ministry of Finance*

**Anupam Mitra**
*Dy.Director (Securuties Market)*
*Ministry of Finance*

**Recent focus on corporate governance**

Corporate governance (CG) has been a major area of debate and policy focus for a few years now. Corporate governance implies the philosophy embedded in the relationship between a company promoters and management with the shareholders and stakeholders at large. A CG analysis also helps delineate the companies which are just shells (for the benefit of promoters), enterprises (for the benefit of shareholders) and institutions (for the benefit of stakeholders at large). The trajectory of corporate governance, therefore, would run between shells to an enterprise to an institution.

Corporate governance is generally understood to deal with the ways in which suppliers of finance to corporations, i.e. debt holders and equity holders, exercise control and ensure accountability of company management so as to assure themselves of the best possible return on their investment. The need for such monitoring arises because the utility of the agent (the management) may not converge with the utility of the principal (equity holders and debt holders). Further it is impossible to write a complete contract because a contract cannot cover all contingent situations. Perfect monitoring and enforcement of contracts may also be impossible. Thus a positive CG is considered vital to promote investor confidence and enhance faith in the probity of the financial system.

**Initiatives on corporate governance**

History is replete with spectacular business scams in the US (such as Enron and Worldcom), Europe (such as Vivendi) and in India (Satyam) that have shook the world. The run up to the ongoing global financial crisis also indicates governance failure of corporates on several counts. These corporate failures have underlined the importance of proper corporate governance mechanism.

Internationally, there have been a number of initiatives to streamline corporate governance practices. These include The Cadbury Report, 1992, The Greenbury Report 1995, The Hampel Report 1998, The Turnbull report 1999, The Higgs Report 2003, The Smith Report 2003, Redraft of the Combined code 2003, The Sarbanes-Oxley Act, 2002. The S-O Act was a major milestone on ' legally enforced' CG norms, but the fact that the crisis of 2008 came in as a 'black swan' underscores the limitations of a legal centric approach to CG in the absence of self imposed codes of behaviour.

Similar initiatives were taken in India as well. In December 1995, CII set up a task force to design a voluntary code of CG. Between 1998-2000, 25 leading companies voluntarily followed the code. Following CII's initiative, SEBI set up a committee under Kumar Mangalam Birla to design a mandatory and recommendatory code for listed companies. Birla Committee report was approved by SEBI in 2000 and was implemented subsequently. Following CII and SEBI, the Ministry of Company Affairs modified the Companies Act 1956, to incorporate specific corporate governance provisions regarding independent Directors and audit committees. In 2001-02, certain accounting standards were modified to further improve financial disclosure.

**Clause 49: a segmented approach**

Practically corporate governance in India revolves around Clause 49 of the Listing Agreement of SEBI and some provisions relating to audit, constitution of Board of Directors, disqualification of Directors, restriction on number of directorships etc in the Companies Act 1956. Clause 49 contains eight sections dealing with the Board of Directors, Audit Committee, Remuneration of Directors, Board Procedure, Management, Shareholders, Reports on Corporate Governance and Compliance. Some of the features of this Clause are as follows:

- Appointing a stipulated proportion of Independent Directors-At least one-third of the Board should consist of independent Directors if the Board is headed by non executive Chairman. If promoters or their relatives are appointed as non executive Chairman then Independent Directors should consist at least half the Board strength. ("independence" defined as any material, pecuniary relationship, or transactions with the company, other than the Director's remuneration, which in the judgement of the Board may affect a Director's judgement).

- Companies should have 'qualified and independent' audit committee with a majority of independent Directors.
- The Annual Report should disclose details of the remuneration of Directors.
- The Annual Report should contain a management discussion and analysis.
- Annual Reports should contain a separate section on corporate governance detailing compliance with the mandatory and non-mandatory requirements proposed by SEBI.

It is however a different matter how "independent" Independent Directors can be given that they are often handpicked by the promoters. The fact that the promoter himself makes the selection and appointment of independent Directors involves a conflict of interest. This mode of selection creates a sense of obligation and loyalty to the promoters which can interfere with the independent, frank and unbiased expression of opinion in public interest. Directors appointed to the Boards by investing or lending institutions are supposed to be more scrutinising. In India however the role played by such nominee Directors has remained inadequate. It is often suggested that a necessary reform to make Independent Directors truly 'independent' is for the Government or the regulatory authority itself to appoint them. Today there is no mechanism by which an investor can access the view or expertise of an Independent Director. There is no platform from which an Independent Director can talk to a company's shareholder about his participation in Board decisions that affect their interest. Even when a director wanted to resign, he needed to fill up a form (No.32) for which he would have to depend on the company secretary. He would not independently be able to inform that he had resigned, and would continue to be responsible to shareholders, if there was a delay in notifying the authorities by the company.

As can be seen from above corporate governance has been practised in a very narrow sense in India. The structure of corporate governance have in general remained restricted to micro issues like more stringent and rigorous disclosure practices to improve transparency, and more broad based composition of the Board of Directors. (It is a different matter that the reporting system is yet to be fool proof to prevent deliberate misreporting). Since the nineties the corporate sector has witnessed substantive and significant changes in India. This has also influenced the governance culture of Indian business houses. For instance firms that listed abroad had to comply with more stringent disclosure norms. Under pressure from FIIs Indian businesses professionalized their boards and adopted best practices followed elsewhere. Ideally however the concept of corporate governance is much more holistic including the rights and responsibilities of different stakeholders of a firm including Board, managers, shareholders, creditors, suppliers, and in short the economy and the society.

**Public holding as a vehicle for corporate governance**

Corporate governance goes beyond the micro issues like accounting standards, role of Board of Directors and the like. What is of greater significance is the ownership structure of a company that would generate specific incentive alignments- to focus on promoters / shareholders / stakeholders. Large, widely dispersed and broad based public shareholding also enforces corporate governance by subjecting companies to social and market discipline. Public holding increases transparency and accountability.

It was usually felt that a wide and dispersed public shareholding would be a bulwark against possible price manipulation through circular trading or otherwise usually by promoters and those acting in concert. Today however the threat of price manipulation is not restricted from promoters only. Huge financial conglomerates with deep pockets also possess the capacity to wreak havoc in the financial marketplace. While earlier price manipulation by promoters would have adversely impacted the minority shareholders primarily, it is possible that by weaving a complex web of financial transactions huge financial corporations can harm the company itself. The impact of such price manipulation can create unwarranted ripples in the economy at large given the growing links between the real and financial sector. Market manipulation and price rigging is difficult when public shareholding is high and thereby making the market deep. This would also help curb excessive speculation and volatility.

**Debate on public holding in India**

Despite a reservation of 35% for retail at the public issue stage, the shareholding pattern of NSE listed companies show that Indian public on an average hold only about 13% of the equity capital as of March 2009. As against this, the promoters – Indian and foreign- hold about 56% of the capital.

The basic problem is that there is not enough floating stock in the capital market to facilitate efficient price discovery for most of the stocks. Low free float leads to low liquidity which in turn hampers price discovery and makes the financial environment more vulnerable to rigging. In the Indian context the concentration of lion's share of equity in the hands of promoters often ranging between 85 to 90 per cent has made a mockery of the concept of listed company. The case is worse for some listed PSEs where public shareholding is even less than one per cent. For instance, NMDC Ltd which is a Navaratna CPSE has a public shareholding of 1.62% while MMTC Ltd. has a public shareholding of only 0.66%. It is a fact that this low float was the result of esops, rather than any divestment effort, which got listed under relaxed conditions. But when the level of public shareholding is so low the minority shareholders have to put up with the 'tyranny of oppression' of majority shareholders.

While a number of companies are listed on BSE there is complete illiquidity in a large number of such listed stocks. For instance about 4887 companies were listed in BSE as on March 31, 2008 whereas stocks of only 2528 companies were frequently traded. It is possible that some of the companies whose stocks are illiquid have "disappeared" and investors have no clue about their investments. It is not unlikely for some of them to be 'shell' companies meant to facilitate cross holding across other related entities including subsidiary companies. It is also possible that illiquidity is the result of lack of interest in that company. Whatever may be the cause; illiquidity makes a stock vulnerable to price manipulation, insider trading and demands greater vigilance of the regulator. According to Som, (2006) the persistence of ineffective corporate governance has also led to too many small funds remaining in the low market capitalisation trap over a long period of time.

**The Statutory position**

The Securities Contract Regulation Rules as amended in 2001 and the listing agreement as amended by SEBI Circular of 2006 now provide the initial and continuous listing requirement. The SCRR now provides that a public company seeking listing of its securities on a stock exchange is required to satisfy the exchange that at least 10% of each class or kind of securities issued by it was offered to the public for subscription. The amended Rule 19(2)(b) of the Securities Contracts (Regulation) Rules, 1957, provides that a company seeking listing on a stock exchange shall offer:

(i) at least 25% of each class or kind of securities to the public for subscription,
or

(ii) at least 10% of each class or kind of securities to the public for subscription subject to the conditions that:
   a. minimum 20 lakh securities are offered to the public,
   b. the size of the offer to the public is a minimum of Rs.100 core, and
   c. the issue is made only through book building method with allocation of 60% of the size to the qualified institutional buyers.

The regulator can, however, relax listing requirements for a Government company. The securities taken or agreed to be taken by the Governments or select financial institutions do not form part of 10% or 25%, as the case may be, of the public offer. With this amendment, SEBI withdraw the special dispensation for select sectors. But it can still waive or relax the strict enforcement of any listing requirement under the SCRR.

The continuous Listing Agreement now provides:

The following companies shall maintain the minimum level of public shareholding at 10%:

a. a company which offers or has in the past offered at the time of initial listing less than 25% but not less than 10% of the total number of issued shares of a class or kind, and
b. a company where the number of outstanding listed shares is two crore or more and the market capitalization of such company in respect of shares of such class or kind is Rs.1000 crore or more.

(ii) In all other cases, the company shall maintain public holding of at least 25%.

The requirement of continuous public shareholding, however, does not apply to government companies, infrastructure companies and companies referred to BIFR. If a company does not comply with the relevant level of public shareholding as stated above or fails to comply with it at any time in future, it shall increase public shareholding to the relevant level within 2 years. It can increase the public shareholding by issuance of shares to public through prospectus, offer for sale of shares held by promoters, sale of shares by promoters in minority shareholders. The public shareholding for this purpose would comprise shares held by entities other than promoters and promoter group and share held by custodians against which depository receipts are issued overseas.

Currently ADR/ GDR are excluded from the definition of public float in India. In some countries ADR/GDR are included in the definition of public float. A ratio of ADR/foreign float to domestic float or thresholds for non institutional domestic holding is prescribed to prevent misuse by companies which are seeking to list with a minimal domestic public float but large FII/ ADR/GDR holding.

**Initiatives by the Government**

The Government has mooted a proposal to raise the threshold level of minimum public holding in a listed company to 25%. It also seeks to homogenize the requirement for initial and continuous listing. It is also proposed that the relaxation available to public sector enterprises may be discontinued and they should also be brought under the 25% rule. As of now, the word 'public' or ' promoter' is not unambiguously defined. These are two sides of the same coin, so defining one would automatically define the other. Different definitions given in various guidelines at times create confusion and inconsistency. To be effective, the definition should take into account the extent of cross holding, pyramid ownership structures and such other mechanism of control which have been amply brought out by many in the context of holding company structures. Given the current restrictive definition of 'promoter' the issue of 'acting in concert' gets camouflaged. That is why it is not only the issue of threshold level of public holding that is important

, but redefining the term public or promoter or both. So it is suggested that only entities which are directly or indirectly not linked to the promoters should become part of the "public". Such entities are FIIs, Banks, Insurance Companies, Pension and Provident Funds, Mutual Funds, Individuals/retailers. On the other hand any entity having stake directly or indirectly before the IPO of a company should be treated as a promoter.

## Conclusion

While the threshold percentage of public share holding is not important beyond a point, what is required is a reasonable share of public holding to ensure adequate liquidity, efficient price discovery and one that ensures a position of comfort and 'value' for the minority shareholders. In the case of Satyam Computers the promoters had only 8.3 per cent of equity at the time of crisis, which too pledged. Even five years before it had a stake of about 20 per cent only.

There is a need for companies to enhance corporate governance norms taking the corporate structure and culture to the level of stakeholder institutions. The current low level of public float militates against all of these objectives necessitating a redesigning of corporate ownership structure of listed entities through greater role for the public/ minority share holders. At the same time a phase out schedule to reach that threshold has to be worked out to avoid disruption in the securities market during the transition phase.

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Authors are with the Capital Markets Division of Department of Economic Affairs, Ministry of Finance. Views are personal.

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