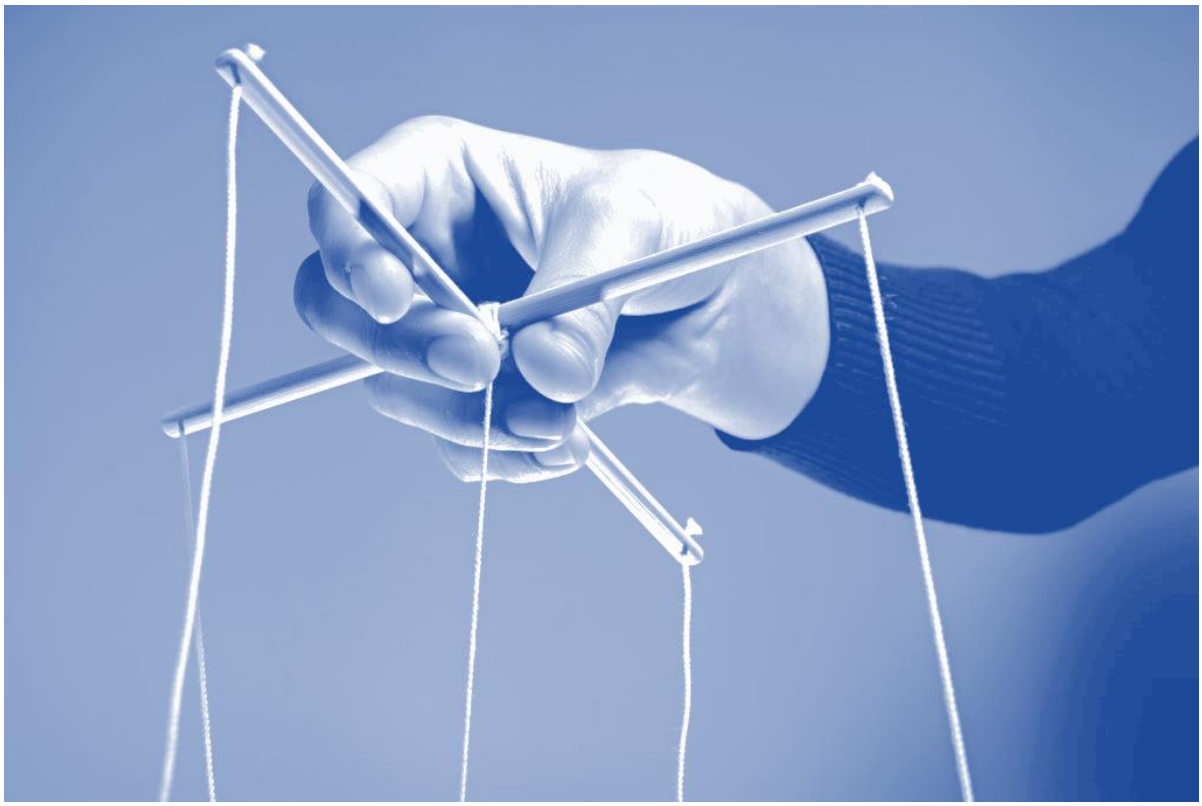
SEBI's challenge to 'control' corporate India

The shift to the concept of person-in-control and away from promoter is SEBI's recognition of the market's maturity. However, in bringing in this change, it must not compromise the measures brought in to empower non-controlling shareholders.



Picture source: The Scholarly Kitchen

SEBI is considering a shift in the concept away from 'promoter' to 'person in control'[1] to align with the new market reality, and a tacit move to parallel global practices. An increasing number of companies are listing in India without a discernable promoter, yet with investors holding special rights or greater decision-making opportunities. The increasing institutionalization of shareholding (to 34% in 2018 from 25% in 2009[1]), and the decreasing promoter equity (to 50% in 2018 from 58% in 2009[1]) in

[1] *Source: SEBI's consultation paper on 'Review of the regulatory framework of promoter, promoter group and group companies as per Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018'*

the top 500 companies indicates changing market structure, one that balances better between the promoters' and non-promoters' interests, and sometimes almost equal rights.

While SEBI's is tipping its hat to the new trends in shareholding, the change to 'person-in-control' will require SEBI to answer two opens questions:

1. **How will control be defined?**
   IND AS 110 on Consolidated Financial Statements defines control as "*An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee*." But this is a specific definition that applies for the purpose of consolidating financial statements and is used in the context of an investor-investee relationship. However, this definition doesn't cover market structures – like the Maruti Suzuki India Limited and the Suzuki-owned Gujarat plant – where control is established without a direct investor-investee relationship.

   SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 defines control to include "*the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.*" The SEC defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." These definitions suggest that persons in control as those that can direct management. Therefore, private equity players and other strategic investors could be considered 'in control', since several of these have board seats, control rights, and veto rights. But when lenders take board seats in defaulting companies, they too will have control rights and veto rights post debt default; will lenders then too be classified as persons-in-control?

2. **Who will be included in the definition of 'persons in control'?**
   While the market structures are indeed changing, a dominant set of Indian listed companies continue to remain family-controlled, with dispersed shareholding of the promoter group across family members and holding companies. In this context, several family members not active in the company's daily operations or governance structures may escape the definition of persons in control. If so, this

can possibly allow the misuse of the 'majority of minority' vote, as family members not in control can vote in support of the management decision. This will mean that the noose around related party transactions will be loosened. One can argue that family members not in control can vote independently and need not be tied to management proposals, but in the Indian context, that is a near impossibility.

The definition of who is in control can extend to sets of non-family promoter groups as well. Can Rakesh Gangwal claim to not be in control of INDIGO, while remaining a promoter, given the Bhatia faction has several one-sided control rights embedded into the Articles of Association? Like NR Naryana Murthy, he too can argue that he is a promoter, but not in control. Of course, holding under 5% is different from holding over 30% equity. We are standing on a slippery slope.

SEBI has been pushing for accountability of the board. Recently, the regulator suggested that independent directors should be appointed in a two-step process, one of which requires shareholder approval by majority of minority. SEBI has also articulated roles and responsibilities of board committees and is increasing the burden of communicating with investors for boards. Its current proposal rests on the case that companies are more board-driven.

Will a board in India investigate a promoter, like Microsoft investigated Bill Gates? While boards are indeed evolving, and corporate governance standards have improved over the past few years, the strategic direction and several difficult decisions continue to rest with the promoter.

Although SEBI is being cognizant of new trends in capital markets, it needs to ensure that the changes it seeks does not diminish the measures that empower non-controlling shareholders.

moneycontrol

This is a modified version of the blog that was published on moneycontrol.com, which can be accessed here: https://www.moneycontrol.com/news/opinion/sebis-challenge-defining-control-in-corporate-india-6922431.html

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