INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD • INDIA

Equity Markets with Controlling Shareholders

Sidharth Sinha

W.P. No. 2011-04-02
April 2011

The main objective of the working paper series of the IIMA is to help faculty members, research staff and doctoral students to speedily share their research findings with professional colleagues and test their research findings at the pre-publication stage. IIMA is committed to maintain academic freedom. The opinion(s), view(s) and conclusion(s) expressed in the working paper are those of the authors and not that of IIMA.

INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD-380 015
INDIA

Equity Markets with Controlling Shareholders

Sidharth Sinha
Indian Institute of Management, Ahmedabad
Email: sidharth@iimahd.ernet.in

Abstract

In early 2008 the Finance Ministry issued a consultation paper on "Requirement of Public Holding for Listing". The Finance Minister also declared in his 2009-10 budget speech that the threshold for non-promoter public shareholding for all listed companies would be raised in a phased manner. This paper discusses the cross-country research on concentrated share ownership and household participation in equity markets. The paper argues that instead of 'forcing' controlling shareholders to dilute their positions the government can achieve its objective more effectively by enhancing minority investor protection in the short run and creating more owners by improving the "Ease of doing business" in the long run.

Equity Markets with Controlling Shareholders

Equity markets in India account for a small proportion of household savings and corporate financing. The RBI Report on Currency and Finance 2005-06 concludes in its chapter on financial markets, "Despite significant improvement in trading and settlement infrastructure, risk management system, liquidity and containment of volatility, the role of the Indian capital market (equity and debt) has remained less significant as is reflected in the savings in the form of capital market instruments and resources raised by the corporates.".

The small role of stock markets in savings and investments has implications for stock market efficiency. The Raghuram Rajan Committee[1] finds that only the market for the top 200 stocks, their derivatives and index derivatives satisfies the three conditions for an efficient market: immediacy, depth and resilience.[2] Trading statistics show that trading on the Indian stock exchanges is concentrated in select securities. The top 10 securities account for almost a third of total turnover and the top 100 securities account for 80-90% of total turnover. The volatility of the Indian stock market continues to be on the higher side relative to other developed and developing country markets.

The functioning of equity markets is linked to the pattern of equity ownership in terms of trading behaviour and access to information and analysis. In India, as in most countries, other than the US and UK, ownership of firms is concentrated in family based business groups.[3] Since the controlling shareholder does not trade his holdings the 'floating stock' and market liquidity is reduced. Concerned by the lack of liquidity in stock markets, in early 2008, the Finance Ministry issued a consultation paper[4] which would require companies to maintain a minimum public shareholding higher than current levels. It also proposes to limit the word 'public' to individual investors and exclude financial institutions and corporate bodies. The proposals are yet to be finalized for implementation.The government adopted a similar approach in the 1970s when it required MNCs in India to dilute their shareholdings. However, at that time pricing was under the Controller of Capital Issues which fixed prices that were extremely attractive for buyers. In the current situation investors

---

[1] "A Hundred Small Steps : Report of the Committee on Financial Sector Reforms", Government of India, Planning Commission, New Delhi, 2009

[2] Immediacy is the ability to execute trades of small size immediately without moving prices adversely. Depth refers to the impact cost of executing large trades. Resilience is the speed with which prices and liquidity of the market revert back to normal conditions after a large trade has taken place.

[3] In fact according to Villalonga and Amit (2008) even in the United States, where ownership dispersion is at its highest, founding families exercise a significant degree of control over a third of the 500 largest corporations and over more than half of all public corporations.

[4] "Discussion Paper: Requirement of Public Holding for Listing", Ministry of Finance website : http://finmin.nic.in/reports/Discussion%20Paper%20Public%20Holdings.htm

may be reluctant to invest in shares and controlling shareholders unwilling to issue shares at prices acceptable to public investors, especially if firms have alternative sources of financing.

Recent research on financial development has highlighted the role of minority investor protection in the presence of controlling shareholders. Enhanced minority investor protection reduces the attractiveness of concentrated ownership by reducing the 'private benefits of control'. It will also increase the attractiveness of 'public shareholding' by assuring minority investors that they will not be expropriated. According to several indicators the current level of minority investor protection in India is inadequate. This paper argues that instead of mandating a high minimum level of public shareholding a better approach to stock market development would be to significantly strengthen minority investor protection.

The paper is organized as follows. Section 1 describes the role of equity financing and the relatively small contribution of public equity markets in corporate financing in India. Sections 2 examines the relatively small role for equity markets in household savings in India and the reasons for cross country differences in household participation rates in stock markets. Section 3 reviews the literature on concentrated ownership and its relationship with minority investor protection. Section 4 provides information on investor protection issues in the Indian market and Section 5 concludes.

1. Equity financing

This section reviews the basic theory of corporate financing to highlight the importance of equity financing relative to other sources of external financing. This is supported by empirical evidence relating the development of equity markets to overall economic growth. Finally, we assess the role of equity markets in corporate financing in India, especially in the recent high growth period.

Role of Equity markets in corporate finance

In the perfect market models of Modigliani-Miller capital structure is irrelevant and there is nothing special about equity. However, information asymmetry between 'insiders' – managers or controlling shareholders - and outside financiers gives rise to the familiar problems of moral hazard and adverse selection. The moral hazard problem is usually referred to 'agency problems' in which outside financiers are principals and the inside managers or controlling shareholders are agents. In several models of moral hazard outside debt is the optimal security to address agency problems (Tirole 2006). The 'default' characteristic of debt, when inside equity investors receive no payoff in the event of default, provides the maximum incentive for insiders to 'behave'. In the case of adverse selection Myers and Majluf (1984) show that debt is the preferred security in the 'pecking order'. Debt is less

information sensitive than equity and the informed inside issuer suffers less underpricing as a result of adverse selection. Debt is also favoured because of the benefits of interest tax shields.

The 'default' characteristic of debt also gives rise to costs of financial distress. Interest on debt and scheduled repayments are mandatory whereas dividends are discretionary and equity is in perpetuity. When internal cash flows are low and the firm is financially constrained in raising external funds (a situation of 'financial distress') the moral hazard and adverse selection problems may be severe enough to force the firm to forego profitable investment opportunities in order to meet debt servicing obligations. Situations of financial distress also heighten the conflict of interest between shareholders and debtholders. This conflict gives rise to the 'debt overhang' problem of Myers (1977) where even a positive NPV project may not be in the interest of shareholders to finance. While shareholders bear the full cost of the project they share the value addition with debtholders. In a situation of financial distress the residual value for the shareholders may be less than their investment. Shareholders may also have a perverse incentive to take on a negative NPV project so long as it has a sufficiently volatile cash flow – referred to as the 'asset substitution' problem. These expected costs of financial distress reduce ex ante firm value.

The optimal capital structure, therefore, requires a sufficient amount of equity so that the costs of financial distress are not excessive. In fact private placement of equity to financial institutions such as private equity and venture capital funds can overcome some of the moral hazard and adverse selection disadvantages of public equity through due diligence and structuring of equity claims. These kinds of equity financing are especially important for new and high growth firms which are the major drivers of innovation and economic growth.

The empirical relationship between economic growth and financial development, including stock market development, has been examined by Levine and Zrevos (1998). They find that the initial level of stock market liquidity and the initial level of banking development (bank credit) are positively and significantly correlated with future rates of economic growth, capital accumulation, and productivity growth over the next 18 years, even after controlling for initial income, schooling, inflation, government spending, the black market exchange rate premium, and political stability. According to the study, the evidence suggests that stock markets provide different financial functions from those provided by banks, or else they would not both enter the growth regression significantly. The authors do not find that stock market size, as measured by market capitalization divided by GDP, is robustly correlated with growth. According to the authors, "Simply listing on the national stock exchange does not necessarily foster resource allocation. Rather, it is the ability to trade ownership of the economy's productive technologies that influences resource allocation and growth".

Equity Financing in India

In India equity financing by a company is classified as public issues, rights issue and private placement. Public issue can be further classified into Initial public offer (IPO) and Further public offer (FPO). In a private placement an issuer makes an issue of securities to a select group of persons not exceeding 49, and which is neither a rights issue nor a public issue. Since these securities are allotted to a few sophisticated and experienced investors, the stringent public disclosure regulations and registration requirements are relaxed.

During the recent high growth period of 2003-04 to 2008-09 public equity issues increased significantly compared to the immediately preceding years. In 2007-08 equity issues crossed Rs.80,000 crores, almost equal to the total amount raised in the previous three years. However, with the onset of the financial crisis equity issues were down to approximately Rs.15,000 crores in 2008-09. As shown in **Table 1** during this period equity financing, while large in absolute terms, was only about 7% of the total debt financing in the form of bank credit and private placement of debt securities. The above comparison is based on data for equity issues and private placement that also includes financial firms. From the perspective of financing of real investments it may be appropriate to exclude financial firms. When financial firms are excluded equity issues by non financial firms account for only 5% of the total of private placements by non financial firms and bank credit.

Table 1: Sources of financing

Rs. crore	Public Equity Issues	Gross non food bank credit	Private Placement
2002-03	1,457	137,306	66,948
2003-04	18,949	108,367	63,901
2004-05	24,388	271,366	83,406
2005-06	27,372	405,052	96,473
2006-07	32,901	396,400	145,866
2007-08	85,426	401,650	212,725
2008-09	14,272	399,400	202,745
Total 2003-04 to 2008-09	203,308	1,982,235	805,115

Source: Public equity Issues SEBI Handbook 2009 Table 12; Private Placement SEBI Handbook 2009 Table 6; Bank credit RBI Handbook 2009 Table 48

Overall, public equity issues appear to account for a small proportion of total financing. It is useful to point out that while the contribution of equity markets is small bond markets are non existent. Most bonds are privately placed.

Private placement of shares or convertible securities by a listed issuer can be of two types: Preferential allotment and Qualified Institutions Placement (QIP). QIP was introduced in 2006 and is limited to Qualified Institutional Buyers which basically consists of financial institutions but excludes promoters. Preferential allotments can be made to financial institutions as well as promoters. In order to prevent the misuse of preferential allotments SEBI requires that the price cannot be below the average of the weekly high and low of the closing prices during the six months preceding the relevant date; or the average of the weekly high and low of the closing prices during the two weeks preceding the relevant date. There is also a there year lock-in period for the securities allotted on preferential basis to promoter or promoter group. As can be seen from **Table 2** QIPs were large during the peak year of 2007-08 but negligible during 2008-09 with the decline in the stock markets. Interestingly preferential allotments were large during the same year perhaps representing an attempt by promoters to raise their holdings at low prices.

Table 2: Equity raised through Qualified Institutions' Placement (QIP) and Preferential Allotment

Rs. crore	QIP	Preferential Allotment
2006-07	4,963	
2007-08	25,525	24,027
2008-09	189	40,608

Source: QIP: SEBI Bulletins, Preferential allotments: NSE Fact Book 2009 (page 37)

It is useful to compare the pattern of domestic financing with the pattern of external capital inflows as presented in **Table 3**. The three main sources of capital inflows are foreign direct investment (FDI), foreign portfolio investment (FPI) and external commercial borrowings (ECB). Almost 80% of FDI is in the form of equity, with the balance representing reinvested earnings. Portfolio investment is in the form of FII investment which is almost 90% in equity. There is also a modest amount of portfolio investment in the form of ADRs and GDRs. External Commercial Borrowings represent loans and were large during 2007-08 and 2008-09. Over the period 2003-04 to 2008-09 total FDI was more than twice the amount of ECB and FPI was almost equal to the ECB. Therefore, equity flows account for almost three quarters of the total external capital inflows during this period.

This pattern of external capital inflows is not fully market determined because of government restrictions on debt inflows in the form of ECB and FPI. However, it is possible to conjecture that external equity financing makes up for the lack of domestic equity financing.

Table 3: External Capital Inflows

Rs. crore	FDI	Portfolio Investment	External Commercial Borrowings
2002-03	24,397	4,675	(8,263)
2003-04	19,830	51,898	(13,274)
2004-05	26,947	41,419	24,149
2005-06	39,457	55,357	11,610
2006-07	102,652	31,630	73,889
2007-08	137,434	118,348	91,310
2008-09	158,579	(64,206)	32,397
2003-04 to 2008-09	484,899	234,446	220,081

Source: RBI Handbook 2009 Table 143

Summing up, the role of public equity issues in external financing of firms is small. Large amounts of equity are issued to promoters through preferential allotments. Firms also use Qualified Institutional Placements (QIPs) for raising significant amounts of equity. The majority of external capital inflow is also invested in equity.

2. Equity in Household savings

Household savings play an important role in financing the savings-investment gap of government and corporate sectors. This section examines the allocation of household financial savings to equity as well as survey data on participation by households in equity markets in India. The low participation rates are considered a puzzle and several studies attempt to provide explanations. The factors which affect participation rates will be relevant for policy makers in terms of increasing household participation rates.

Household financial savings in "Shares and debentures" in India

In India the savings of the household sector are estimated separately under financial assets and physical assets. The savings of the household sector in physical assets are not estimated independently. CSO estimates the household investment and transfers the same to the account of household saving in physical assets. The savings of the household sector in financial assets, gross financial savings, is measured as the change in financial assets of households. It is estimated using the economy-wide Flow of Funds (FOF). The economy is classified into six sectors and nine instruments. The six sectors are corporate; public; rest of world; banking and other financial institutions; and the residual being the household sector comprising heterogeneous entities like individuals and unincorporated business enterprises such as sole proprietorships and partnership

concerns, and non-profit institutions. The household sector is treated as the residual sector because unlike the corporate and government sectors, which have their balance sheets and income-expenditure accounts at annual intervals to base their annual savings estimates on, the household sector does not have such accounts for all its constituents such as pure households, HUF, self employed persons, trusts, proprietorships etc.

Almost 50% of household savings takes the form of physical assets. Over 50% of financial savings is in bank deposits and claims on government. Life insurance funds account for 15-20 %.[5]

As shown in **Table 4** the proportion of 'shares and debentures' in gross financial savings has generally been less than 5% during the period 1990-91 to 2008-09, except in the initial years and the most recent period. The proportion of shares and debentures in total financial savings declined to 3% in 2008-09. This may reflect the decline in share prices as well as the transfer of savings from stocks and mutual funds to bank deposits.

Table 4: Per cent of Gross Financial Savings of the Household Sector in the form of Shares and Debentures and Life Insurance Funds

	Shares and debentures			**Life insurance Funds**
Year	Total	Private corporate business	Mutual funds	Total
1999-00	7.70%	3.40%	3.40%	11.20%
2000-01	4.10%	3.10%	1.30%	12.90%
2001-02	2.70%	1.50%	1.80%	13.50%
2002-03	1.70%	0.80%	1.30%	15.50%
2003-04	0.10%	1.10%	1.20%	13.00%
2004-05	1.10%	1.40%	0.40%	15.10%
2005-06	4.90%	1.30%	3.60%	13.50%
2006-07	9.00%	3.70%	5.30%	17.10%
2007-08	12.40%	4.40%	7.90%	17.40%
2008-09	2.60%	4.20%	-1.40%	19.50%

Source: SEBI Handbook 2009, Table 104

It is not possible to obtain separate estimates for household savings in shares and debentures. In the recent period mutual funds accounted for almost 75% of the investment in shares and debentures by households. Investment in shares and debentures through mutual funds is more volatile than direct investment. Income/Debt oriented schemes account for about 60% of total asset under management at

[5] Given the popularity of Unit Linked Insurance Plans (ULIPS) a large proportion of this may represent investment in shares and debentures

the end of March 2008 with equity schemes accounting for the balance 40%. The share of Income/Debt oriented schemes increased to 70% in 2008-09.

Household participation rates in stock markets

The theoretical benchmark for household participation in stock markets is 100%. This is based on the result that a risk averse investor will always take some part of an actuarially fair gamble (Arrow 1970). To the extent shares are seen as at least actuarially fair all households should participate in stock markets. Therefore, even the relatively high level of household participation in the developed countries is seen as a puzzle since the participation rates are much below 100%. Of course, not all households

Consistent with the low share of financial savings invested in shares and debentures household surveys also indicate a low rate of participation in stock markets. The first Survey of Indian Investors was conducted during1998-99 by SEBI and NCAER. (SEBI 2009) A follow up survey was conducted during April-December, 2000 based on a sample of 2,88,081 households located in geographically dispersed rural and urban areas. The findings of the Survey were published in March, 2003.

Table 5: Proportion of Investor Households in all Households in States Owning Different Type of Instruments - All-India (Top 5 and bottom 5 states by equity participation)

States	Total Equity	Total Bonds	Total M.F.	Total Investors
Top 5				
Gujarat	24.1%	26.2%	17.4%	34.9%
Pondicherry	13.1%	3.2%	20.9%	16.2%
Chandigarh	12.1%	13.6%	4.7%	24.2%
Goa	9.7%	2.3%	0.7%	9.8%
A.P.	8.5%	18.4%	6.7%	24.0%
Haryana	8.1%	8.9%	5.1%	13.6%
Bottom 5				
Tamil Nadu	3.9%	4.5%	19.9%	7.7%
West Bengal	3.4%	3.2%	4.9%	4.7%
Kerala	3.1%	2.7%	9.1%	4.9%
Delhi	3.0%	6.7%	13.9%	7.8%
Maharashtra	2.5%	2.1%	9.5%	4.1%
All India	**3.7%**	**5.4%**	**6.7%**	**7.4%**

Source: SEBI Handbook 2009, Table 96

According to the survey, as shown in **Table 5**, about 3.7% of households hold stocks directly. About 7% of household invest in mutual funds. Since the break-up of the mutual fund investors between equity and debt funds is not available it is not possible to get an estimate of indirect participation in

the stock market. The extent of direct participation in equity markets varies significantly across states. Gujarat has the highest participation rate of 24% which is similar to the direct participation rate in the US.

An alternative estimate of the participation rate is provided in the Raghuram Rajan Committee Report. There are roughly 10 million depository accounts in the country. Assuming one account per family and assuming five individuals per family, direct ownership of equities does not exceed 50 million people. This would give a participation rate close to that obtained by the household surveys.

There are a few basic facts about the determinants of household participation in the stock market. Participation is strongly increasing in wealth. This can arise if participation involves fixed costs. Wealthier households who have more to invest will find the fixed cost less of a deterrent. Household education is another determinant. Education reduces the fixed costs of participating, by making it easier for potential investors to understand the risk-reward trade-offs in the equity markets, and to deal with the mechanics of setting up an account, executing trades, etc.

International data on direct stock market participation is available from Giannetti and Koskinen (2010) for 26 countries. As can be seen in **Table 6**, which gives the data for a select group of countries, while the richer countries generally have higher participation rates there is significant difference within them. For example, while Australia has a direct participation rate of 40% in the case of France it is only 15%. India's participation rate at 3.3% is at the lower end of the countries.

Table 6: Investor participation rates in the domestic stock markets and closely held shares (select countries)

Country	Participation rate (direct)	% closely held market capitalization
Australia	40%	42%
UK	30%	34%
Japan	30%	45%
US	26%	40%
Canada	25%	28%
France	15%	62%
Hong Kong	14%	56%
Taiwan	13%	27%
Germany	9%	64%
Italy	7%	50%
India	3%	54%
Sri Lanka	2%	48%
Turkey	1%	62%

Source: Giannetti and Koskinen (2010), Table 1

Giannetti and Koskinen (2010) find that investor protection measured in several alternative ways is a significant variable for explaining cross country variations in the stock market participation rate after controlling for per capita income, stock market capitalization as a percentage of GDP and average years of schooling,

Several papers relate household participation to other less obvious factors. These include trust and insurance penetration.

Investing in equity requires an element of trust since in the case of equity there is no collateral and no promised return or repayment.. Guiso, Sapienza, and Zingales (2008) identify 'trust' as an important factor determining the rate of stock market participation. According to them the decision to invest in stocks requires not only an assessment of the risk– return trade-off given the existing data, but also an act of faith (trust) that stock market information is reliable and that the overall system is fair. They define trust as the subjective probability individuals attribute to the possibility of being cheated. The study finds that trust has a positive and significant effect on stock market participation and a negative effect on dispersion of ownership. These effects are present even after they control for law enforcement and legal protection. [6]

The availability of insurance against large negative shocks could encourage risk averse individuals to take on the higher risk of stocks in order to earn higher returns. Gormley, Liu and Zhou (2010) using country-level empirical analysis find strong support for a connection between insurance penetration, participation rates, and savings. Stock market participation rates across countries are positively correlated with the presence of a large, private insurance market. This correlation holds strongly even after controlling for other country-level characteristics, including measures of investor protection, trust, legal origin, and economic development.

While the above studies provide evidence on factors associated with the level of stock market participation in a cross section of countries it is useful to understand the dynamics of the evolution of stock market participation over time. Guiso,Haliassos, Jappelli (2003) describe the increase in participation rates in Europe during the 1990s. Prior to this period participation in the stock market was limited to a relatively small segment of the population, the few households in the very upper tail of the wealth distribution, relatively well educated, and with little exposure to other sources of risk, except possibly entrepreneurial risk. This picture changed considerably over the 1990s. In the UK, the

[6] Their stock market participation data is the same as that used by Giannetti and Koskinen (2010). Average trust in each country is obtained from the World Values Survey. It is computed as the fraction of individuals in each country who reply yes to the question, "Generally speaking, would you say that most people can be trusted or that you have to be very careful in dealing with people?"

proportion of direct stockholders went up from less than 9% in 1983 to 22% in 1998. A large part of this development is associated with the privatisation of public utilities that took place in the UK before other European countries. In Italy - the country with the lowest direct participation - the proportion of households that invest directly in the stock market went up from 4% in 1989 to 7.3% in 1998, also taking impetus from the privatisation process. Total participation, direct or indirect, rose during the 1990s in all European countries and in the US. Most of the increase is due to the growth of indirect stockholding: the fraction holding stock directly shows in fact little change. This highlights the role of mutual funds in increasing participation in stock markets.

Summing up, household participation in equity markets is influenced by a variety of factors. The effect of factors such as wealth, education and investor protection are relatively straightforward. Researchers have identified other factors such as level of trust and availability of insurance which are significant in empirical tests even after controlling for the effects of wealth, education and investor protection. The experience of Europe indicates that privatization can play an important role in stock market participation. The role of mutual funds is also important in enabling indirect participation.

3. Ownership concentration

Concentrated ownership has been observed in most countries with the exception of US and UK. La Porta, Lopez-De-Silanes and Shleifer (1999) were the first to systematically document concentrated ownership as the norm in most countries. They examine the ownership structures of the 20 largest publicly traded firms in each of the 27 generally richest economies using data for 1995. The firms are classified into those that are *widely held* and those with *ultimate owners*. A corporation has a controlling shareholder (ultimate owner) if this shareholder's direct and indirect voting rights in the firm exceed 20%.

They find that 36 percent of the firms in their sample are widely held, 30% are family-controlled, 18% are State-controlled, and the remaining 15% are divided between the residual categories. In an average country, the *ultimate family owners* control, on average, 25% of the value of the top 20 firms. For the sample as a whole at least 69% of the time, families that control firms also participate in management. Overall, the controlling shareholder does not have another large shareholder in the same firm in 75% of the cases, and this number is 71% for family controlling shareholders. According to the study, relative to shares with differential voting rights and cross-holdings, pyramidal ownership appears to be a more important mechanism used by controlling shareholders to separate their cash flow ownership in sample firms from their control rights. 26% of firms that have ultimate owners are controlled through pyramids.

Private benefits of control

Concentrated ownership and control gives rise to the problem of private benefits of control. This is the expropriation of minority shareholders by diversion of company resources through such mechanisms as tunneling and related party transactions. The concentrated owner realizes the full benefit of any diversion but bears the cost of decline in firm cash flows only to the extent of his shareholding in the firm. A concentrated owner with a 20% shareholding enjoys the full benefit of diverting a Rupee of cash flow but suffers only a 20 paisa cost of lower firm cash flows. Ultimate owners can reduce their financial ownership below their control rights by using shares with superior voting rights; by organizing the ownership structure of the firm in a pyramid; or through cross-shareholdings. In this way they are able to derive private benefits of control with the least cost.

In countries such as the US and UK ownership is relatively diffused and shareholders control managers only indirectly through the board of directors. This separation of ownership and control gives rise to agency costs in the form of managerial perquisite consumption and shirking as well as pursuit of non value maximizing objectives such as sales growth, empire building and employee welfare at the cost of firm value. However, even in these countries a large proportion of shares are held by informed, sophisticated institutional investors, many of whom have non negligible stakes. They are often referred to as activist investors, with hedge funds as the most important recent example. These countries also have a more active market for corporate control which is expected to provide a disciplining effect on management.

Therefore, while concentrated ownership does not suffer from the agency problems of separation of ownership and control, it is subject to the problem of 'private benefits of control'. Since private benefits of control are not observable researchers have attempted to infer the magnitude from market transactions. Dyck and Zingales (2004) measure the extent of private benefits of control as the difference in the price per share paid in a privately negotiated transfer of a controlling block and the price that can be observed in the market once investors have absorbed the fact that there will be a new controlling shareholder. The rationale for this method is that the price per share an acquirer pays for the controlling block reflects *both* the cash flow benefits it expects to receive as a shareholder (which include the value of any improvements it expects to make in the firm's performance) and any private benefits stemming from its controlling position. By contrast, the market price of a share just after the change in control is announced should reflect only the cash flow benefits that *all* shareholders expect to receive under the new management. The study is based on 393 control transactions that took place between 1990 and 2000, in companies representing 39 different countries.

The study finds that control premiums averaged 14% of the equity value of a firm. In countries where private benefits of control are large, ownership is more concentrated, and capital markets are less

developed by several measures such as number of IPOs/ population, the number of listed firms/population, and the external market capitalization relative to GDP. Their explanation for this relationship is that in countries where a controlling party can appropriate a larger share of the value of a company, entrepreneurs will be more reluctant to take their companies public. If they sell a minority position, outside investors will be willing to pay less for it than what it is currently worth to the entrepreneur, because they factor in the possibility that a new acquirer will dilute the value of the company in the future. As a result, entrepreneurs are reluctant to sell. At the same time, when control value is high they do not want to sell a majority of votes in the market because they will not receive an adequate compensation for it.

Several institutional variables, taken in isolation, seem to be associated with a lower level of private benefits of control: better accounting standards, better legal protection of minority shareholders, better law enforcement, more intense product market competition, a high level of diffusion of the press, and a high rate of tax compliance. The authors consider the possible role of tax enforcement in reducing private benefits, and thus indirectly enhancing financial development, as probably the most important new fact to emerge in their analysis. This is because tax authorities and non-controlling shareholders have a common objective: to ascertain the value produced by a company and get a share of it.

Ownership Concentration in India

In India there is the concept of a promoter as the controlling shareholder. Promoter includes persons 'who are in control of the issuer' or 'who are instrumental in the formulation of a plan or programme pursuant to which specified securities are offered to public' (SEBI 2009). A minimum 'promoter's contribution' of 20% of the share capital is necessary for a public issue. This minimum contribution is required to be locked in for a period of three years. Most Indian promoters are families.

As shown in **Table 7,** the share of Indian promoters in the total shareholding pattern has remained steady at 45-50%. The share of foreign promoters increased only marginally from 5.6% in December 2002 to 7% in March 2008. However, the share of FIIs more than doubled from 4.6% to 11%. The share of non institutional Indian investors declined marginally from 17% to 13%.

Table 7: Per cent of total number of shares outstanding owned by different groups

	March 2009	December 2001
Indian promoters	51%	46%
Foreign promoters	7%	5%
Financial Institutions	6%	8%
Foreign Institutional Investors	8%	5%
Mutual Funds	3%	4%
Bodies Corporate	6%	10%
Individuals	13%	18%
Others	6%	4%
Total	100%	100%

Source : NSE Factbook 2009, 2002

Moody's and ICRA (2007) have examined corporate governance in 32 companies in 16 prominent family-controlled Indian business groups. These companies cover a broad cross-section of Indian industry, and include 13 Sensex companies accounting for about 40% of the total Sensex market capitalization. According to an extract of the survey results shown in **Table 8,** many families exert control with less than 50% shareholding, whereas others own more than 74%. Promoter shareholdings in the study ranged between 26-90%, with a median of 50%. Many Indian family-controlled groups have complex corporate structures. In such cases it can be difficult to assess ownership and control on the basis of public information.

Table 8: Promoter Holdings (Select promoters and companies)

Figures in US$bn	Company	Market capitalization March 2007	Promoter holding
Tata	**Tata Steel**	**11.5**	**31%**
	TCS	26.2	82%
	Tata Power	4.7	32%
	Tata Motors	7.5	33%
	Tata Chemicals	1.7	32%
Birla	**Grasim Industries**	**8.1**	**25%**
	Aditya Birla Nuvo	4	39%
	Hindalco Industries	5.2	27%
	Ultra Tech Cement	3.4	53%
Reliance (MDA)	**Reliance Industries**	**86.8**	**51%**
	IPCL	3.6	47%
Reliance (ADA)	**Reliance Energy**	**8.3**	**34%**
	Reliance Comm.	33	67%
	Reliance Capital	10.3	52%
	Adlabs	0.6	55%

Source: Moody's and ICRA (2007) (Figure 1)

Given the widespread prevalence of family controlled business groups there is a need to explain their emergence and persistence. Khanna and Palepu (2005) offer the following explanation for the rise of concentrated ownership in emerging economies like India. In the initial stages of economic development many institutions necessary for the functioning of product markets, labor markets, and financial markets are typically missing or underdeveloped. Groups often perform functions traditionally performed by market institutions in more mature markets. One such important function is similar to venture capital, consisting of identifying promising new business opportunities in the economy and exploiting them with in-house risk capital and managerial talent, which are traditionally in short supply in the economy at large. This, in turn, leads to the observed predominance of the business group type of organizational form in emerging economies. In the case of India this process was aided by the state providing a protected environment, closed to foreign or domestic competition through export and import controls and tight industrial licensing policy.

Tunneling by Indian business groups

The expropriation of minority shareholders is often referred to as tunneling. While there is significant anecdotal evidence on tunneling there are few systematic studies. Like all 'private benefits of control' tunneling can be difficult to measure.

Bertrand, Mehta and Mullainathan (2002) provide a methodology for detecting the presence of tunneling. A business group usually completely controls several independently traded firms and yet has significant cash flow rights in the form of direct shareholding in only a few of them. This discrepancy in cash flow rights between the different firms under control creates strong incentives to transfer, or *tunnel,* profits from firms with low direct shareholding to firms with high shareholding. They devise a test to measure the changes in profits of group firms (the response) relative to changes in the profitability of other firms in the same industry (the industry shock).

Consistent with the theory they find that the profitability of group firms on average underresponds to the industry shock and this is larger in low direct shareholding firms. When this analysis is conducted separately for operating and non operating profits they find that it is the underresponse to non operating profits that drives the results. Group firms' operating profits are, in fact, *more* sensitive to their own industry shock. From this they conclude that profits are tunneled from low cash flow rights firms by manipulating the non operating profit component of total profits. A related implication is that transfer pricing, which would affect operating profits, is not an important source of tunneling in India.

Gopalan, Nanda and Seru (2007) examine the characteristics of intra-group loans, often cited as a mechanism for tunneling. In their sample they find that group loan inflows are large and, on average,

constitute 59% of operating profits in the year a firm receives loans. Their evidence indicates that groups extend loans to financially weaker firms and significantly increase the extent of loans when member firms are hit with a negative earnings shock. The loans are made on terms more favorable than those of comparable market loans, consistent with the loans being used to provide subsidized support.

Summing up, while concentrated ownership is common around the world there are significant differences in the extent of expropriation of minority shareholders as measured by the private benefits of control. This has lead to the distinction between efficient and inefficient controlling shareholder systems as in Gilson (2006). In the inefficient system poor minority investor protection allows the cost of private benefit extraction to exceed the benefits of more focused monitoring of management so that minority shareholders are net worse off from the controlling shareholder's monitoring effort. Alternatively, in the case of efficient controlling shareholders strong protection of minority shareholders allows the benefits of more focused monitoring to exceed the costs of private benefit extraction so that minority shareholders are net better off.

4. Minority investor protection

In recent years there has been extensive focus on the role of corporate governance in financial development. Several international organizations have developed indices to make cross-country comparisons on various dimensions of corporate governance.

The World Bank's *Doing Business 2010* presents quantitative indicators on business regulations and the protection of property rights that can be compared across 183 economies and over time. One of the 11 indicators is 'protection of investors' which measures minority shareholder protections against directors' misuse of corporate assets for personal gain. The data come from a survey of corporate lawyers and are based on securities regulations, company laws and court rules of evidence. As shown in **Table 9** India was ranked 41st along with other countries such as Botswana, Bulgaria, Chile, Mexico, Indonesia and Romania. It may also be relevant that India is ranked 182 out of 183 countries in Enforcing Contracts so that even if the laws and regulations may be in place enforcing them may not be easy.

Table 9: Doing Business 2010 : India

Stage of business	Rank (Total 183)
Starting a Business	169
Dealing with Construction Permits	175
Employing Workers	104
Registering Property	93
Getting Credit	30
Protecting Investors	41
Paying Taxes	169
Trading Across Borders	94
Enforcing Contracts	182
Closing a Business	138
Ease of Doing Business (Overall)	**133**

Source: World Bank and IFC, *Doing Business 2010: Reforming Through Difficult Times*

The World Economic Forum produces the annual Financial Development Report, based on the Financial Development Index (FDI) which provides a score and rank for 55 countries according to the level of their financial development. India is ranked 30 on 'Corporate Governance' and 50 on 'Contract Enforcement'. Within Corporate Governance India is ranked 24 on 'Protection of minority shareholders' interests' and 35 on 'Efficacy of corporate boards'.

The Asian Corporate Governance Association (ACGA), Hong Kong, released a white paper on Corporate Governance in India, in January 2010.. According to the paper despite wide-ranging developments in regulation and policy, corporate governance reform in India has not adequately addressed the issue of accountability of promoters to other shareholders. The paper identifies the following specific problems:

Shareholder Meetings and Voting: Shareholder meetings and proxy voting processes in India lack efficiency and accountability. There is a need to conduct voting on all resolutions at AGMs and EGMs meetings by a poll with an independent scrutineer to count and audit the vote.

Related-Party Transactions: India has notably weak regime governing related-party transactions. Typical related party transactions that listed companies engage in include spinning off valuable assets from listed companies to unlisted private entities for the benefit of promoters; spinning off investments in group companies to a holding company, valuing the investments at a large discount to fair value, then buying back the shares of the holding company from the market; and shifting new

business to unlisted private entities and letting an affiliated listed company pay for branding and distribution costs.

Regulation needs to be overhauled and minority shareholders accorded much greater protection. For example, there is a need to introduce stricter regulation on related-party transactions, including giving independent shareholders the powers to approve large transactions above a certain limit and enhancing disclosure requirements on other material transactions.

Preferential Warrants: The scope for the misuse and abuse of warrants in India is considerable. Regulation of their issuance to promoters needs to be tightened. The issuance of preferential shares, warrants or other securities to promoters and other connected persons should be prohibited, as in other markets.

Corporate Disclosure: The scope, depth, timeliness, consistency and formatting of corporate financial disclosure in India could be greatly improved among listed companies

The Auditing Profession: The Indian auditing profession is highly fragmented. It would benefit from some consolidation as well as an independent audit regulator. The Government should establish an independent regulatory body for the audit profession. Such a body could draw its talent from among the many experienced auditors in India, including those who have worked overseas.

Overall the report points out that relying largely on independent directors, usually appointed by controlling shareholders, and greater corporate disclosure as the primary mechanisms to protect the interests of minority shareholders is likely to prove weak and insufficient.. While Board reform is fundamentally important it needs to be complemented by a proper regime for the regulation of related-party transactions.

These recommendations are consistent with the self assessment of India's financial sector carried out by the Committee on Financial Sector Assessment (CFSA) set up by the Government of India and the Reserve Bank in September 2006. In the area of Corporate Governance the committee expressed the following concerns:[7]

> In India, there is a comprehensive corporate governance framework in place for listed companies and the listing agreement forms an important pillar of corporate governance framework. There is a need to strengthen the corporate governance framework with regard to risk management in listed companies. Listed companies need to disclose the reasons for non-compliance with non-mandatory requirements.

[7] "Financial Sector Self Assessment finds System Broadly Robust but Identifies Specific Concerns" RBI Press Release, March 30, 2009

Steps need to be taken to protect the interests of shareholders, such as equitable treatment of all shareholders including minority shareholders and alternate methods of voting, which are convenient for shareholders and in which investor associations can play a constructive role. There is a need for strengthening the disclosure mechanism to bring about greater transparency in ownership structures and stringent penal action needs to be taken where such practices are unearthed. Penal provisions for fraudsters may be strengthened in corporate law by providing for disgorgement of gains and confiscation of assets. The corporate governance framework needs to evolve with the changing times and there is a parallel need to strengthen the corporate governance framework for unlisted companies

5. Conclusions

In a system of controlling shareholders minority investors discount the price they are willing to pay for shares to account for the possibility of expropriation. This raises the overall cost of equity capital for new as well as existing firms. Firms make fewer public issues and fewer households participate in equity markets. Minority shareholder protection through laws and regulation and their public enforcement can reduce the private benefits of control. This may also result in a reduction of ownership concentration. However, from a long term perspective, the controlling shareholders system can only be diluted by encouraging the entry of new entrepreneurs. It is in this context that India needs to improve its poor ranking on “Ease of doing business”. An environment where doing business is “not easy” is conducive for maintaining the position of incumbent business groups. Such an environment is most punishing for new and small businesses.

References

Arrow, Kenneth J (1974)., Essays in the theory of risk bearing, Chapter 3, page 100

Bertrand, Marianne, Paras Mehta, Sendhil Mullainathan (2002), "Ferreting Out Tunneling: An Application to Indian Business Groups", *The Quarterly Journal of Economics*, Vol. 117, No. 1, pp. 121-148

Gopalan, Radhakrishnan, Vikram Nanda, Amit Seru (2007), "Affiliated firms and financial support: Evidence from Indian business groups", *Journal of Financial Economics* volume 86, Issue 3, Pages 759-795.

Gilson, Ronald J. (2006), "Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy", 119 *Harvard Law Review* 1641

Guiso, L., P. Sapienza, L. Zingales (2008): "Trusting the stock market", *Journal of Finance* 63, 2558–2600.

Guiso, L., M. Haliassos, T. Jappelli (2003): "Household stockholding in Europe: Where do we stand and where do we go?", *Economic Policy* 18, 117–164.

Khanna, Tarun and Krishna Palepu, (2005): "The Evolution of Concentrated Ownership in India: Broad Patterns and a History of the Indian Software Industry", in "*A History of Corporate Governance around the World: Family Business Groups to Professional Managers*", Randall K. Morck, editor, NBER, University of Chicago Press

La Porta, Rafael, Florencio Lopez-De-Silanes, Andrei Shleifer (1999), "Corporate Ownership Around the World", *The Journal of Finance*, 54:2, 471

Levine, Ross and Sara Zervos (1998): "Stock Markets, Banks, and Economic Growth", *The American Economic Review*, Vol. 88, No. 3, pp. 537-558

Moody's-ICRA Corporate Finance (2007), "Corporate Governance and Related Credit Issues for Indian Family-Controlled Companies", Special Comment

Myers, Stewart C. (1977), "Determinants of corporate borrowing", *Journal of Financial Economics*, vol. 5, issue 2, pages 147-175

Myers, Stewart C. and Nicholas S. Majluf. (1984). "Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have", *Journal of Financial Economics*. 13:2, pp. 187-221

NSE Indian Securities Market Review 2009, Table 3.6, page 78

RBI Handbook (2009) Handbook of Statistics on the Indian Economy

SEBI Handbook (2009) Handbook of Statistics on the Indian Securities Market, 2009

SEBI (2009) Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations

Tirole, Jean (2006), Theory of Corporate Finance, Princeton University Press, Chapter 3: Outside Financing Capacity

Villalonga, Belen, and Raphael Amit. (2009) "How Are U.S. Family Firms Controlled?" *Review of Financial Studies* 22, no. 8 : 3047–3091.