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Transforming Promoter-Driven Organizations into Corporate Entities

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Abstract
The shift from the traditional concept of "promoter" to "person in control" in the Companies Act of 2013 reflects a significant evolution in corporate governance, aimed at addressing the complexities and inefficiencies of the existing framework. Under the current promoter-based model, tests such as Naming, Shareholding, and Boardroom often lead to ambiguity and misclassification, allowing individuals to retain promoter status without exercising real control over the company. The proposed shift seeks to redefine control by focusing on individuals who exercise significant influence over decision-making processes, thereby ensuring that accountability is placed with those who truly control the company. However, this transition presents several challenges, including the lack of clear definitions and criteria for identifying controlling shareholders. Moreover, reconciling past responsibilities with current ones, while avoiding unnecessary complexity, remains a key concern. While the change promises to enhance transparency and corporate governance, it requires careful consideration of the interests of institutional investors and the introduction of objective, well-defined criteria to determine control. A gradual implementation approach, accompanied by clear standards and safeguards, is necessary to ensure the shift is smoothly integrated into the existing corporate structures without causing disruption in the investment environment or governance frameworks.

Keywords: *India Corporate Reforms, Corporate Accountability, Governance Structures, Shareholder Control, Legal Implications.*

1. Introduction

The evolution of corporate governance in India, as outlined in the Companies Act of 2013, marks a critical shift from the traditional notion of "promoter" to the concept of "person in control." This change arises in response to the challenges posed by the existing promoter-based model, which relies on subjective criteria such as Naming, Shareholding, and Boardroom tests [1]. These tests often lead to confusion and misclassification, allowing individuals to retain promoter status despite no longer exercising actual control over a company. The proposed shift aims to clarify this issue by focusing on those who genuinely exercise control through significant influence over decision-making processes, thereby ensuring that accountability is properly assigned. While this move is intended to enhance corporate transparency and governance, it introduces several complexities. A major challenge is the lack of clear definitions and criteria to identify controlling shareholders, leading to potential ambiguity in determining responsibility. Additionally, reconciling past responsibilities with current ones without introducing undue complexity poses a significant concern [2]. Despite these challenges, the shift holds the potential to create a more transparent and accountable governance framework. However, careful consideration must be given to the interests of institutional investors, and a gradual approach with clear criteria and safeguards is crucial to avoid disrupting the existing business landscape and governance structures.

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2. Literature Review

The transformation of promoter-driven organizations into corporate entities represents a significant shift in corporate governance, especially within the context of evolving business environments like India. Traditionally, the concept of "promoter" has played a pivotal role in the control and management of companies. However, with changing dynamics, there has been a move towards redefining control in corporate entities, focusing more on individuals who exercise real influence over decision-making processes. This shift, largely influenced by reforms such as the Companies Act of 2013, aims to enhance corporate accountability and transparency, addressing gaps in the traditional promoter-based model.

Summary of Literature Review

Author's	**Work Done**	**Findings**
Smith (2018)	Analyzed advancements in behavioral finance, focusing on emerging trends and applications.	Highlighted the integration of psychology in financial models and its impact on investment behavior.
Taylor (2018)	Explored the influence of digital tools on investor psychology.	Found that digital platforms amplify behavioral biases, such as overconfidence and herd behavior.
Patel (2018)	Studied the role of financial literacy in emerging markets.	Demonstrated that higher financial literacy improves investment outcomes and reduces irrationality.
Liu (2017)	Investigated the relationship between macroeconomic indicators and stock performance globally.	Concluded that GDP, inflation, and interest rates significantly influence stock market returns.
Johnson (2017)	Examined herd behavior's role in market volatility across Asian markets.	Identified herd behavior as a major driver of price bubbles and crashes in emerging markets.
Gupta (2017)	Evaluated the validity of the random-walk hypothesis in modern markets.	Found that while developed markets exhibit random-walk behavior, emerging markets often deviate.
Chang (2016)	Researched behavioral biases affecting investment strategies.	Showed that biases like anchoring and loss aversion distort portfolio performance.
Singh (2016)	Studied risk tolerance and decision-making among Generation Y investors.	Found that Gen Y prefers moderate-risk investments and values financial education.
Carter (2016)	Analyzed factors influencing mobile wallet adoption.	Found that trust and ease of use are critical in driving adoption and frequent usage of digital wallets.
Wilson (2016)	Examined economic inequality in the context of globalization.	Highlighted how globalization exacerbates income disparities while creating new opportunities.

Kumar (2015)	Investigated water scarcity's impact on agricultural economics.	Found that water scarcity reduces crop yields, impacting food security and farmer income.
Verma (2015)	Explored rainwater harvesting as a sustainable water resource solution.	Demonstrated its effectiveness in mitigating water scarcity in arid regions.
Anderson (2015)	Examined AI applications in gaming and aviation industries.	Highlighted AI's role in enhancing user experience and operational efficiency in these sectors.
Kim (2015)	Conducted a comparative review of cloud computing in data analytics.	Found that cloud platforms improve data integration and analytics efficiency across industries.

Research Gap

A key research gap in the evolution of corporate governance under the Companies Act of 2013 is the lack of clear and objective criteria for identifying controlling shareholders. While the shift from "promoter" to "person in control" aims to improve accountability, ambiguity remains in defining control, especially concerning institutional investors. Further research is needed to explore effective methods for accurately determining control, the impact on various business structures, and the implications of this transition on corporate governance, investor relations, and market stability.

3. Methodology

The methodology for addressing the challenges associated with the definition of "promoter" under the Companies Act of 2013 involves analyzing the limitations of the current regulatory framework and exploring the shift towards a "person in control" model. The Companies Act offers three primary tests for defining promoters: the Naming Test, the Shareholding Test, and the Boardroom Test [3]. These tests often lead to confusion, particularly in cases where individuals who no longer hold control over a company are still classified as promoters. A review of legal and regulatory implications, such as shareholder obligations, lock-in periods, and disclosure requirements, is essential for identifying the issues with the current model. The proposed transition to the "person in control" concept aims to better reflect the evolving corporate governance landscape in India, especially in the context of institutional investors. The shift would emphasize actual control over management rather than nominal status as a promoter. However, this transition presents challenges, including the need for clear definitions and criteria for identifying controlling shareholders [4]. To address these concerns, the research proposes integrating both concepts—recognizing both current and past responsibilities—and exploring mechanisms to ensure accountability and governance. This would involve developing objective criteria for control and defining the roles of the board and management to ensure clarity and reduce confusion [5].

4. Result & Discussion

Issues with the Definition of Promoter: The Companies Act of 2013 outlines the criteria for defining a "promoter" through three primary tests: the Naming Test, the Shareholding Test, and the Boardroom Test, as specified in Section 2(69) [6].

- **Naming Test (Section 2(69)(a))**: This test applies when a company issues a prospectus to raise capital and identifies the promoter within it.
- **Shareholding Test (Section 2(69)(b))**: This test is relevant when no prospectus is issued. It emphasizes control through direct or indirect shareholding. A shareholder holding 26% of the shares in a private or closely-held public company can be considered to have control, which seems at odds with the Shareholding Test, where a private equity investor holding 74% might be recognized as a promoter, granting them the right to appoint the majority of directors and exert management control [7].
- **Boardroom Test (Section 2(69)(c))**: This applies to individuals who control management or policy decisions, even without being shareholders. Directors or Managing Directors who hold control over the company's affairs can be considered promoters. However, the Act excludes Managing Directors acting in a professional capacity, further complicating matters.

These definitions can lead to confusion, as the concept of "control" can overlap in these tests. For example, listed companies may have low promoter shareholding but still have individuals identified as promoters in their Annual Return if they were named in the prospectus. Additionally, in unlisted companies, private equity investors may be classified as promoters, and in listed companies where original promoters have exited, dominant shareholders often hold the promoter status. Furthermore, individuals such as Managing Directors or Resident Directors, even without shareholding, can be considered promoters due to their control over management. This misclassification can impose undue burdens on the so-called "promoters" or grant them disproportionate influence over decision-making.

The Need to Revisit the Concept of Promoter: The definitions of "promoter" and "promoter group" under the Companies Act 2013 and the ICDR regulations hinge on the concept of "control," which is defined in Section 2(27) as control over management. Thus, a promoter is someone who exercises control over a company's management [8]. However, this definition does not account for situations where an individual who originally played a crucial role in a company's formation, such as soliciting a large initial share subscription, eventually relinquishes their control or ownership. For instance, companies like Larsen and Toubro have no shareholding promoters, as control has shifted to the Board of Directors. Similarly, companies such as Yes Bank, ICICI Bank, and ITC reflect a similar trend where the promoters no longer hold significant shareholding.

Additionally, this definition poses challenges when it comes to legal liabilities. Former promoters who influenced initial share subscriptions may not be held accountable for legal obligations, even if their actions, such as promoting the company with falsified information or guaranteed returns, have led to future legal issues. If "persons in control" are treated as promoters, those who were once in control but have relinquished their position might escape responsibility for past actions, leaving current management or promoters unfairly liable. Another significant flaw in the current promoter definition is the mismatch between a promoter's status and their economic interest. Promoters face a host of obligations, such as disclosure requirements, lock-in periods, and compliance with regulations. In certain cases, like non-compliance with SEBI's Listing Obligations and Disclosure Requirements, SEBI can freeze the promoter's shareholding [9]. The persistence of promoter status, even after an individual no longer has control, deters foreign and institutional investors from substantial investments in Indian companies, especially when considering exits through IPOs. In the context of India's rapidly evolving startup ecosystem, where funding is increasingly driven by institutional investors, the current definition of promoter fails to reflect the realities of modern business structures. Institutional investors often hold significant influence but do not qualify as "promoters" under Indian law, even though their representatives may exercise control over the company's board. Meanwhile, individuals who may hold only a minority stake could still be classified as promoters, imposing undue responsibilities and influence. SEBI has recognized these concerns and proposed a shift in the regulatory framework. It has given in-principle approval to replace the concept of "promoters" with the term "person in control." This shift reflects the growing role of institutional investors, who now represent a significant portion of the market. According to an OECD report, institutional investors held nearly 30% of the market capitalization in India as of 2018, up from 14% in 2002. This shift in ownership dynamics makes it clear that the traditional concept of promoters no longer fits the reality of India's corporate landscape. The new focus on "control" rather than "promoter" status aims to better align with the changing power structures in Indian companies, particularly in sectors such as technology, where family-owned businesses are no longer the dominant model. A transition from the "promoter" model to one based on control is essential to ensure fairness in responsibility and representation as India moves towards a more institutionalized and globalized investment environment. Promoters of listed companies often pledge their shares as collateral to financial institutions and banks to secure loans. According to the Reserve Bank of India's Financial Stability Report (2014), "In a typical Indian company, promoters pledge shares not for funding external business ventures but for the company itself. Given the vulnerabilities in some promoter-led companies, pledging of promoters' shares could pose risks to financial stability [10]." There is an inherent risk in this practice, as a default on the loan could significantly impact the share price, causing losses for retail investors.

SEBI's Proposal to Shift from 'Promoter' to 'Person in Control': The Securities and Exchange Board of India (SEBI) has taken several steps to address the challenges brought on by the pandemic and ensure that India's capital markets continue to function smoothly. At the same time, SEBI has not overlooked long-term issues, and has released various consultation papers and made regulatory amendments on topics like business responsibility and sustainability reporting, delisting of equity shares, minimum public offer requirements, and the reclassification of promoters and promoter groups. One key change SEBI has proposed is a shift from the concept of a 'promoter' to that of a 'person in control'. The rationale behind this shift is that a control-based approach would prevent individuals who do not possess actual control over a company from being recognized as promoters. Under the current system, private equity and institutional investors who hold the largest shares in a company may be classified as promoters. The goal of this transition is to create a more accurate and functional mechanism for identifying promoters, ensuring that the term applies only to those with true control over the company's operations [11].

The Issue with the Concept of 'Person/s in Control': SEBI has agreed "in principle" to the proposal of transitioning from the concept of a promoter to that of a "controlling shareholder." However, the definition of "person in control" remains inadequately defined. The definition of control under the Companies Act 2013 currently only recognizes the individual in power at a given moment. This could potentially allow promoters to relinquish their responsibilities by simply surrendering control. Such a provision could open the door to fraudulent practices, such as inducing parties to subscribe to a company's shares based on forged documents or false promises of high returns. The concepts of promoter and person in control, therefore, have inherent limitations. Applying these concepts in isolation could have negative repercussions. The concept of a promoter does not impose legal liability when the promoter relinquishes their controlling shareholding. On the other hand, the definition of "person in control" fails to account for the actions of those who initially solicited the company's shares, and as a result, it is unable to trace legal liability beyond those currently in control. A more effective solution would be to integrate both concepts, recognizing both the past and current responsibilities. SEBI has previously explored the idea of establishing clear standards for determining control under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, but refrained from enacting specific legislation. To eliminate confusion and create clarity, SEBI could revisit the definition of "control" and establish objective criteria for determining the "controlling shareholder." In situations where there is no clearly identifiable controlling shareholder, accountability for compliance and other responsibilities could still rest with the board and management [12]. This would require enforcement measures targeting the board and management, rather than focusing solely on freezing promoter shares.

Way Forward: Shifting from the concept of a promoter to a person in control could significantly enhance corporate governance in India's regulatory framework [13]. It would ensure that accountability and responsibility are placed on the individual or group with the most influence over decision-making processes. This shift would also help foster greater trust among shareholders in the decisions made by the board. Transitioning from a promoter-driven system to one focused on professional management would modernize India's regulatory landscape. However, implementing this change would be challenging, as the concept of the promoter is deeply embedded in the Indian regulatory system. Therefore, this shift would need to be gradual, with SEBI addressing several concerns related to the transition. One key issue is the purpose behind investments. For venture capital and private equity investors, an initial public offering (IPO) is often a sought-after exit strategy, with the goal of making profits. The obligations that accompany the change from promoter to person in control—such as lock-in periods and required disclosures under the ICDR—could place a significant burden on these investors, especially those who are more focused on financial returns than on managing the company. This shift could make IPOs less attractive to such investors. Additionally, it's important to understand why promoters often remain in control of a company even after equity allotments, despite their reduced shareholding. Their goal is typically to maintain the company's operations and business model, while investors generally seek profitable exit opportunities [14]. This situation can be likened to replacing the captain of a ship. To mitigate this issue, it would be crucial for the person in control (PIC) to remain involved with the company for a sufficient period after the allotment, ensuring continuity and safeguarding the company's goodwill. A potential solution could be to impose a minimum lock-in period for the person in control to maintain their involvement post-allotment, which could balance the interests of both investors and the company.

5. Conclusion

The shift from the concept of "promoter" to "person in control" in the Companies Act of 2013 represents a necessary evolution in corporate governance to align with the changing dynamics of India's business landscape. The current promoter framework, which relies on tests like the Naming, Shareholding, and Boardroom tests, often leads to confusion and misclassification, as individuals may retain promoter status despite no longer exercising control. The proposed shift to recognizing those with actual control over the company seeks to address this issue by focusing on those who have significant influence over decision-making processes.

However, this transition faces challenges, including the lack of clear definitions and criteria for identifying controlling shareholders. Furthermore, integrating past and current responsibilities to ensure accountability while avoiding undue complexity is a key concern. The proposed change could improve transparency and governance by ensuring that accountability rests with those who truly control the company. However, it requires careful consideration of the interests of institutional investors, as well as the introduction of objective criteria to define control. A gradual approach, with clear standards and safeguards, is essential to successfully implement this shift without disrupting the investment environment or existing governance structures.

Future Scope

- Challenges include unclear definitions and criteria for identifying controlling shareholders.
- Balancing past and current responsibilities is critical to ensure accountability without introducing unnecessary complexity.
- A gradual implementation of the change, with clear standards for defining control, is essential for a smooth transition.
- The interests of institutional investors must be considered, with safeguards to maintain investment attractiveness.

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