Ownership and Control—III

A Study of Inter-Corporate Investment

R K Hazari

THE findings of this study firmly support the view that inter-corporate investment especially by Investment companies, is one of the major instruments of control in the corporate sector. The growth of inter-corporate investment is a logical and integral part of the process of extension of control, investment and management which in greater or lesser degree accompany corporate growth. The problem has therefore to be viewed empirically. High rates of taxation of income and wealth, along with several other factors, encourage the rich to disperse and impersonate their holdings of .wealth, largely through the creation of companies and trusts, since these enjoy a number of advantages ranging from comparatively lower or no taxation at all to independent and perpetual existence. Corporate bodies have the further advantage that they can, if they so desire, secure public participation .in their share capital and loans can be raised against the pledge of their shares and debentures.

Decision-making power has to be backed up and maintained with controlling investments which have to come from corporate bodies to the extent that they do not emanate from individuals and trusts. As the corporate sector expands and private proprietorship of business tends to decline, the importance of inter-corporate investment in the ownership and control of corporate bodies is bound to increase.

Capable of Abuse

Intercorporate investment is not inherently anti-social. It provides a flexible mechanism for control of existing undertakings and promotion of new enterprises. Simultaneously, however, it enables controlling interests to maximise their area of control and influence through a chain of minimum and indirect investments. Inter-corporate investment is, therefore, capable of abuse, and the law has to step in to prevent abuses which may be detrimental to the interests of shareholders and even more to the economic development of the country.

A few instances of abuse of inter-corporate investment have been noticed in the course of this study. Several companies, including industrial enterprises, have been found to hold shares in other companies, apparently not so much for investment nor even for the advancement of their own business, as for taking advantage of capital market situations and/or for serving the purposes of their controlling interest. In some cases, it can be clearly perceived that inter-corporate investments (and loans) enable some groups to set up companies the existence of which as working entities appears doubtful and help companies to purchase their own shares indirectly, transfer profits and losses, and to cuter into transactions of a similar nature. There can be little doubt that these abuses are motivated largely by the desire to reduce tax burdens rather than to evade the provisions of the Companies Act. Problems connected with taxation are beyond the scope of this study. Attention Is confined here, therefore, to legal aspect of the problem of checking these abuses.

Amendment of Company Law

Section 372 of the Companies Act, 1956, deals with inter-corporate investments. Under this section, the amount invested in the shares of any other company in the same Group as defined in section 370 should not ordinarily exceed 10 per cent of the subscribed capital of the other company, and the total amount invested in companies in the same Group should not exceed 20 per cent of the subscribed capital of the investing company. Investments above these limits require the approval of shareholders of the investing company and of the Central Government. These restrictions do not apply, however, to banking and insurance companies (which are regulated by special legislation), investment companies, private companies, and to holding companies in respect of their subsidiaries. Nor do they apply to investments by managing agents and secretaries and treasurers in companies under their management. The definition of companies in the same Group has, according to the Company Law, Department, proved too narrow and easy to evade.

The Companies Amendment Bill just passed by the Lok Sabha widens the scope of section 372 considerably. Briefly, the amended section permits a company to invest in the shares of any other company upto 10 per cent of the latter's subscribed capital provided the aggregate investment of the company in the shares and debentures of other companies, whether in the same Group or not, does not exceed 30 per cent of the company's own subscribed capital; of this, not more than two-thirds should be in companies in the same Group. Any investment above these limits will require the consent of shareholders of the investing company, as also the approval of Government. The list of exemptions is practically the same as in the principal Act, except that the amended section also applies to Investment companies, which, however, are not subject to the aggregate limit on investments of 30 per cent of their subscribed capital. Read with the new section 43A, the new section 372 also applies to those private companies which may be deemed to be public companies.

These amendments should enable Government to regulate inter-corporate investment more effectively and to impose some checks on the operations of investment companies which, in spite of their importance as investors on behalf of controlling interests and as speculators on stock exchanges, have been practically unregulated hitherto.

It should be clearly realised, however, that the Company Law Department, as constituted and empowered at present can regulate inter-corporate investment only to safeguard the interests of shareholders of investing companies. It can hardly regulate such investment in the public interest in general.

One can understand the exemption of foreign-owned private companies from the new section 43A, but it is difficult to understand why

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the exemption should be extended to private companies which are wholly owned by other private companies incorporated in India. The latter exemption might encourage the formation of circular chains of private companies wholly owned by one another indirectly.

The Act gives two definitions of Investment companies. One is that of companies the principal business of which is the buying and selling of shares, and the other is that of companies which acquire shares. Most investment companies combine both these activities but the relative importance of these two activities differs. Note (L) to Schedule VI of the original Act allowed investment companies not to disclose their investments in those shares and debentures which are listed at stock exchanges but required them to give full particulars of their investments in unquoted shares and debentures. (Many investment companies have evaded even the latter requirement by tucking away all or nearly all their investments as stock-in-trade under Current Assets avoiding thereby disclosure of any particulars at all. The value of their stock-in-trade is generally "certified by management', presumably without a physical check by auditors). Managing agency companies were similarly exempted from disclosing particulars of their investments in companies under their management. These exemptions were justified on the ground that disclosure of investments might be detrimental to the business of investment and managing agency companies. The validity of this argument is rather doubtful. The amended Act retains the exemption from disclosure of particulars of investments in the case of managing agency companies, but withdraws it from investment companies, including those which put down their investments under Current Assets.

Protection Against Cornering

It is true that the knowledge that the holding by managing agents in a managed company in small can encourage cornering, but non-disclosure of such investments by managing agents in their balancesheets cannot by itself keep back this knowledge from potential cornerers. Cornering of shares of companies listed at stock exchanges has little or nothing to do with disclosure of investments in the balance sheets of their managing agents, It is encouraged by the tempting liquid-resources of some managed companies in which the controlling interest has a very small holding — a piece of information which is secured not from the balance sheet of the managing agency, but from the shareholders' list of the managed company, and inside information. In any event most managing agents have negligible investments in the companies under their management, and leave controlling investments to trusts and other companies in the same Croup.

Government now holds wide powers to frustrate cornering of shares and attempts to displace existing managements which, thus, enjoy an unparallelled degree of protection. Managing agents are hardly likely to lose anything if they have to disclose their investments in managed companies, especially since, in most cases, the share holding of managing agents, if any, is only a small fraction of the total holding by the controlling interest.

As regards investment companies, there is little substance in the argument that disclosure of their investments would inhibit their operations. A similar argument, it may be recalled, was put forward in less enlightened days by managements of public industrial companies. There is no particular reason why investincut companies should be exempted from the general obligation imposed on most other corporate bodies to divulge their investments. Data collected in this study conclusively establish that, companies are controlled, in terms of voting power, by the holdings of investment, rather than managing agency, companies. While the latter have been, severely regulated by the Companies Act, the former had hitherto been free from regulations. This freedom is going to end at last.

Check on Investment Companies

There are a few genuine investment companies which are neither 'holding' companies in the sense of being companies which invest nearly all their funds in the same Group to which they belong, nor are they Share trading' companies which are largely responsible for speculative activities, These genuine investment companies perform a useful function in the capital market, and de serve support and encouragement through relief in taxation, exemp tion from some of the restrictions applicable to 'holding' and share trading' companies, etc. They can be separated from the motley crowd of 'holding' and 'share trading' companies through a process of administrative screening, if they desire to qualify for tax relief, etc, which should be conditional on their continuance as genuine investment companies through each accounting year. A tentative criterion for a genuine investment company can be that the company, whether public or private, should invest or lend more than one-half of its resources outside the Croup to which it belongs. Such a criterion cannot possibly he incorporated in the Company Act for no legal definition of Croups could be adequate, but it may not be difficult to apply the criterion administratively. Abuses can be prevented by publicising the names of all investment companies which are given recognition every year.

There has been a mushroom growth of 'holding' and 'share tradbig' type of investment companies, especially in Madhya Pradesh, Rajasthan and West Bengal, since 1940. This study could not go into the motives behind this mushroom growth, but the statistical and other information collected left little doubt that much of this growth was unhealthy. To discourage the formation and (nominal) working of such companies action under the Companies Act alone will not be enough; among others, Income Tax authorities have also to play their part. With the proposed amend ment of the Income Tax Act, there should be no difficulty in pooling the information and resources available with the two Departments to take co-ordinated action for curbing the anti-social activities of such companies.

The absence of co-ordination so far between the Income Tax and Company Law Departments has, among other things, led to a wide disparity in the estimation of corporate activity by these two Depart ments. According to the Income Tax Department, the number of companies assessed to tax was around 11,000 only in 1958, while for the same year the Company Law Department gave out a figure of about 29,000 as the number of 'companies at work, incorporated in India'. Even when allowance is made for new and inactive corn-

panies and companies not liable to Tax owing to various tax concessions, the disparity in numbers, particularly in West Bengal, is too daring to be glossed over lightly.

Shareholders' Lists

The number of shareholders in leading public companies like Tata Steel, A C C, Hindusthan Motors, etc., is increasing very rapidly. There are many other companies which also have a large number *of* shareholders. The Companies Act allows companies to file a complete list of their shareholders once in three years, and to file only a list of transfers in the other two years. If the shareholders' lists of companics with a large number of shareholders are complete, they are very bulky and difficult to scrutinise. If. on the other hand, they are merely a record of transfers, it is difficult to find out the ownership and control of companies in two years out of three. To enable Government and other interested parties to have compact and comprehensive data on the ownership and control of companies, a compromise arrangement may be suggested on the following lines: companies with less than 5.000 shareholders may submit a complete list of their shareholders every year. Those with a larger number of shareholders need submit only a list of transfers in two years out of three, on condition that they file every year a list of their top 100 shareholders giving their names and addresses and the full extent of their shareholding. This compromise, might necessitate an amendment of section 159 and part II of schedule V of the Companies Act.

Bank Holdings

Some measures have also to be taken to make- shareholders" lists more reliable than they are at present. The Company Law Department can do very little about it. The remedy lies partly with the Reserve Bank, and partly in imposing checks on trusts and *benami* holdings. Regulation of blank transfers is an altogether separate and tricky affair into which it is no! proposed to enter here.

Banks are found to be holding large blocks of shares in many companics, including tonic private and very narrowly owned public companies. It is an open secret that more than 90 per cent of such holdings do not belong to banks as beneficial owners, but are held by them in various capacities on behalf of their clients. The only restriction on share holding by banks *in* operation at present is under section 19(2) of the Banking Companies Act. which limits their holdings in individual companies to 30 per cent of the paid up capital of these companies, or 30 per cent of the paid up capital and reserves of the bank concerned, whichever is less, in the capacity of pledgees, mortgagees or absolute owners. The Reserve Bank has powers under section 36(1) (a) of the above Act to regulate holdings of banks as nominees or trustees, but has not exercised these powers so far.

Registration of shares in the names of banks is widely used for concealing the ownership and control of companies. Allowance may and should be made for use of shares for raising bank credit, which cause for greater transferability of bank-held shares, and the recognition of the status of banks as trustees. but not to the extent of reducing the shareholders' lists of some companies to a fiction! The Reserve Bank could discourage such holdings through moral persuasion and by calling for returns under section 36(1)(a) of the Banking Companies Act. It is difficult to suggest any hard and fast limits on bank holdings on behalf of their clients in any capacity. An operationally feasible ceiling may be placed at 1 per cent of a company's paid up share capital in all cases where the bank concerned is not the beneficial owner. This limit should also apply to executor and trustee companies which are subsidiaries of banking companies. Information on major holdings of this kind collected by the Reserve Bank should be made available to the Company Taw Department.

Concentration of Control

A few tentative observations may now be made on some of the wider issues which arise out of this study. This study did not and could not. within its static and other limitations, make an attempt to measure concentration of control in the private sector. The data collected indicate, nevertheless, that the Groups studied and the areas under their influence arc larger than they would appear to be, if one were to go by the definition of Groups laid down under section 370 (and implied under section 332) of the Companies Act, 1956, and larger also than they are commonly believed to be. It would not be surprising if Groups other than those studied here were also found to control and influence a corresponding wide area of corporate activity.

Variety of Activities

Groups in India, in contract to their counterparts in SOME other companies do not. in general, exhibit horizontal and/or vertical integration of industries in the technical sense. The integration they seek to achieve is basically not technical but financial and managerial. Of the five Groups covered in this study, for instance, the Mafatlals alone can be said to have horizontal and/or vertical integration, though they too have shown a propensity to invest large funds in industries like sugar and shipping, which are not related in the technical sense with their cotton mill business. The Mahindras are also integrated on this principle but they are still too young to be assessed. The investments of Tata industrial companies are generally horizontal or vertical but the Group as a whole has spread its investments pretty far and wide. Investments of Birla industrial companies have, in many cases, little or nothing to do with their own business. The Group appears to be over-burdened with investment and trading companies, and the variety of its industrial interests is remarkable. Sonic of the leading industrial companies in the Group, like Birla Jute and Jiyajeerao Cotton, moreover, combine entirely different occupations.

The great variety of the industrial interests of Groups is. partly, a legacy of the managing agency system and is. partly, due to the relatively small and unstable market for each industry obtaining in the past. Since its inception. the managing agency system has sought to combine trade, finance and management of technically unrelated industries like tea. coal. jute. e,tc. it is possible that if managing agents had resisted the temptation of financial integration, and specialised in individual industries. the country might have been even less industrialised than it is, because nobody else might have been able to establish and manage the industries which have been built up over the last 75 years or so. What might have been useful in the past, however, may

not be equally useful in the future. OF late, Groups have shown a tendency towards excessive diversification of their interests which they seek to achieve, partly, by complete or partial acquisition of old European concerns, and, partly, by proliferating into various unrelated industries. This tendency may help industrialisation in the short run hut can hardly be considered beneficial ultimately.

Groups of the kind we have can. *a priori* secure only the economies of large scale finance and over-all top management, and the advantage of stability if and when faced with major find nations in individual industries. They cannot secure in full measure the technical and technological economies of horizontal and vertical integration, and the economics of specialised management. Many reasons can be given for the relative neglect of marketing efficiency, technological development and trained specialised management in India, but one of the most important among them is that the interests of Groups are far too diffused over industrial as well as non-industrial occupations to enable and induce — them to concentrate their attention on the problems of individual industries.

Government Policy

In fairness to Groups, two specific factors which are partly responsible for intensification of the tendency to proliferate into unrelated industries may be mentioned. One is the fear of nationalisation of basic industries in which certain Groups like the Tatas. for instance, have invested the bulk of their capital, management and prestige. So long as the fear of nationalisation remains, the Groups likely to he most affected by it are bound to hedge their risks by a wider dispersal of their investments.

The other factor is the absence at times of an adequately gainful outlet within their occupation for surplus funds that accumulate in some of the older concerns, especially in cotton and jute industries. While these industries are not too prosperous, as a whole some units in them have fairly large liquid resources which are not ploughed hack into these industries because there is little scope for their expansion and other and newer industries offer better rewards. Cotton companies, in particular, have been diversifying their activities of late by investing their funds in rayon, chemicals, engineering, etc, either by setting up new divisions or through inter-corporate investments. This pattern of growth might help in filling up the gaps in the industrial structure, hut whether it is consistent with Plan priorities and the need to modernise these two leading industries is doubtful. Government has imposed a number of restrictions on the expansion of cotton mills, while in the case of jute, the industry itself, with the approval of Government, restricts production. Though these restrictions have been in existence for many years, Government has not deemed it necessary to follow them up with a positive policy for the planned utilisation of surplus funds available with some companies in these industries.

(Concluded)

Errata

The following corrections have to be made in the article '"Ownership and Control A Study of Inter-Corporate Investment" by R K Hazari, published in the last two issues.

In the issue of November 26. page 1713, lines 7 and 8 should read as: "the net worth ....of these companies amounted to Rs 317 crores", and not Rs 314 crores. In the table on Page 1715, the figure of net worth under Walehand-Minority-Indian should be Rs 17.62 lakhs, and not Rs 14,95 lakhs.

In the issue of December 3, page 1760, Table 11, the number of Tata companies is 55 and not 5. On page 1763, Table 13, line 4 .should be deleted.—*Ed.*

Wheel Forging Press

The 6000 ton hydraulic wheel forging press for the. Durgapur Steelworks has been designed to forge cheese-shaped steel ingots into solid railway wheel blanks, ready for rolling and finishing. in five operations taking less than 90 seconds.

The Wheel and Axle Plant at Durgapur, of which this press will be the primary productive unit, is scheduled to come into service in July 1961. The plant is planned for initial production of 45,000 railway carriage and wagon wheel sets a year (two wheels and one axle per set) with provision for subsequent expansion to 75,000 wheel-sets annually in the future.

THIS IS ONLY AN ANNOUNCEMENT AND NOT A PROSPECTUS

A copy of the Prospectus has been duly filed with the Registrar of Companies, Madras State, for registration. Consent of the Central Government has been obtained to this issue. A licence has been obtained from the Central Government for the establishment of this new Industrial Undertaking. The Madras Stock Exchange Limited has agreed to grant an official quotation for the Shares of the Company and permission to deal in them on the Company complying with the usual and necessary formalities after the closure of the subscription list.

The subscription list will open at the commencement of the Banking hours on Thursday the 15th December 1960 and will close at the close of the Banking hours on Thursday the 22nd December 1960.

Kothari Sugars and Chemicals Limited

(Incorporated under the Companies Act, 1956)

AUTHORISED CAPITAL :
50,00,000 Equity Shares of Rs. 10 each Rs. 5,00,00,000

ISSUED CAPITAL :
8,00,000 Equity Shares of Rs. 10 each Rs. 80,00,000

SUBSCRIBED CAPITAL :
2,50,000 Equity Shares of Rs. 10 each Rs. 25,00,000

PAID-UP CAPITAL :
At the rate of Rs. 5 per share on
2,50,000 Equity Shares of Rs. 10 each Rs. 12,50,000

Out of the above issue, the signatories to the Memorandum, the Directors of the Company and their friends have subscribed among themselves for 1,20,000 Equity Shares of Rs. 10 each to the aggregate value of Rs. 12,00,000. The Madras Industrial Investment Corporation Limited have underwritten 1,50,000 shares out of which they have subscribed for 1,30,000 Equity Shares of Rs. 10 each to the aggregate value of Rs. 13,00,000 and have also agreed to make an open application for a further 20,000 Equity Shares of Rs. 10 each which will rank for allotment on a par with other applications received from the public, making in all Rs. 15,00,000. Out of the balance of Rs. 55,00,000 the Life Insurance Corporation of India have underwritten and have agreed to subscribe and will be allotted 1,50,000 Equity Shares of Rs. 10 each to the aggregate value of Rs. 15,00,000.

The Balance offered for public subscription by the prospectus:
4,00,000 Equity Shares of Rs. 10 each. Rs. 40,00,000

On Application Rs. 5 per share
On Allotment Rs. nil.

The balance of Rs. 5 per share is payable as and when called.

The entire issue (other than the shares allotted to the Directors and their friends) of 6,80,000 shares of the face value of Rs. 68,00,000 has been underwritten.

No shares are issued for consideration other than cash.

BOARD OF DIRECTORS

1. Mr. A. D. SHROFF, "Bombay House", 24, Bruce Street, Fort, Bombay (Chairman).
2. Mr. D. C. KOTHARI, "Kothari House", Kothari Road, Nungambakkam, Madras-31.
3. Mr. A. M. M. MURUGAPPA CHETTIAR, "Chamundeswari Bagh", Santhome High Road, Madras-4.
4. Mr. JAGMOHANDAS M. MEHTA, "St. Vincents", 13, Ridge Road, Malabar Hills, Bombay.
5. Mr. JAYANTILAL R. MEHTA, 75, Warden Road, Bombay-26.
6. Mr. BHUPATI RAI M. GHIA, 18, Carmichael Road, Bombay.
7. Mr. H. C. KOTHARI, "Kothari Bagh", 4-A-A, Nungambakkam High Rd., Nungambakkam, Madras-6.

MANAGING AGENTS

M/s. KOTHARI & SONS (INDUSTRIES) PRIVATE LTD., "Oriental Buildings", Armenian Street, Madras-1.

BANKERS

THE STATE BANK OF INDIA, 1st Line Beach, Madras-1.
THE EASTERN BANK LTD., "Oriental Buildings", Armenian St., Madras-1.
THE BANK OF INDIA LTD., Mahatma Gandhi Road, Fort, Bombay.
THE BANK OF BARODA LTD., 12, Apollo Street, Bombay.
THE INDIAN OVERSEAS BANK LTD., Esplanade, Madras-1.
DEVKARAN NANJEE BANKING COMPANY LTD., 17, Horniman Circle, Bombay-1.

UNDERWRITERS

The Investment Corporation of India Limited,
"Ewart House", Bruce St., Bombay.

The Life Insurance Corporation of India,
Jeevan Kendra, Jamshedji Tata Road, Bombay-1.

The Madras Industrial Investment Corporation Limited,
38, Whites Road, Royapettah, Madras-14.

The Bank of Baroda Ltd.,
12, Apollo Street, Bombay.

BROKERS

BOMBAY

M/s. Dhirajlal Maganlal Purshotamdas,
"Stock Exchange Buildings", Apollo Street, Bombay-1.

M/s. Batlivala & Karani,
Union Bank Buildings, Dalal Street, Fort, Bombay-1.

M/s. Devkaran Nanjee & Co.,
"Devkaran Nanjee Buildings", Horniman Circle, Bombay-1.

M/s. Harkisondass Lukhmidass,
Share Bazaar, 5, Hamam Street, Bombay-1.

M/s. Lewis & Jones,
"Bank of Baroda Buildings," Apollo Street, Bombay-1.

CALCUTTA

M/s. Place, Siddons & Gough Private Limited,
6, Lyons Range, Calcutta.

M/s. G. M. Pyne,
Allahabad Bank Buildings, 14, India Exchange Place, Calcutta-1.