Corporate Governance

An Emerging Scenario

NSE Publication

CORPORATE GOVERNANCE
AN EMERGING SCENARIO

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Editors

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Foreword

Historically, exchanges have contributed to promote good corporate governance in their listed companies through listing and disclosure standards and by monitoring compliance. By raising transparency standards and discouraging irregular practices in the listed companies, exchanges have been able to build up 'reputational capital'. The NSE, like other reputed exchanges of the world, has diligently used these channels (listing and disclosure standards and compliance monitoring) to promote higher standards of governance in the listed companies. The NSE's commitment to corporate governance however goes beyond this narrow self-interest of protecting and promoting its 'reputational capital'. We recognize that while corporate governance may not dictate the economic prospects of a developing country such as India, it certainly plays an integral role in shaping them. Good corporate governance is key to the integrity of corporations, financial institutions and markets, and central to the health of any economy and its stability.

Against this backdrop, the NSE took an initiative of holding roundtable discussions with experts in the field of corporate governance, which included regulators, academicians and practitioners. The discussions and the ideas emerging from them culminated in this report. Some of the papers presented here focus on the unfinished agenda in regulatory reforms to ensure best practices in corporate governance in India and the problems that arise from a legal centric approach to corporate governance. In addition, this volume contains certain empirical papers which attempt to answer some puzzling questions such as does good corporate governance increase market value; does ownership pattern have a bearing on corporate governance in Indian firms; do past events of corporate governance failures have a pattern and are there lessons to be learnt from them and so on.

In putting together this volume on corporate governance issues, the aim has been not to duplicate work already done on the topic but to make use of the expertise of our authors to set a new action agenda for reforms in the arena of corporate governance. This set of papers, I am sure, would be useful for policy makers, regulators, practitioners, researchers and the investor community at large and also contribute to the current debate on corporate governance.

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We would like to put on record our gratitude to the authors who contributed their expertise, insights and prescriptions to this volume, all for the enhancement of corporate governance in general, and more specifically in the Indian context. Their views and perspectives on a variety of corporate governance issues enriched the debates during the brainstorming session and the writers' conference. We would also like to thank them for their patience and understanding during the several rounds of discussions and reviews of their individual papers.

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Introduction

Corporate governance is a dynamic field of study and practice. Borrowing an expression from Mark Tully, there are “no full stops” in this ongoing inquiry. But there are time-outs when one may be permitted to pause and take stock. A decade is as good a time window as any to carry out such an exercise; it is all the more appropriate when that decade happens to be the one heralding a new millennium.

And what a decade it has been for business and society around the world! A bagful of corporate scams, the virtual breakdown of international financial systems, massive state bailouts even in the so-called free market economies, enormous environmental disasters on land and at sea, unbelievable breaches of business trust and reputational loss, blatant grabbing and expropriation of natural resources from the world’s poor—the decade of 2000–2010 had it all. The large corporation as an organisational format that was already under attack for its overarching power and malefic influence came to be increasingly viewed as an instrument of individual greed and collective deceit.

Who should be held responsible for this state of affairs? Is there something inherently wrong with the corporate format that had been nurtured over the centuries as a potent instrument to establish business competitiveness and the success of nations? Is there something the matter with the laws and regulations governing corporations, or with their effective application? Are the people who run these corporations—the directors, the managers, the employees—at the root of the problem? The list of questions is never-ending, while the answers are at best elusive and inconclusive. The fifteen papers in this collection—dealing with conceptual and regulatory aspects as well as empirical and experiential observations—seek to explore some of these issues.

We begin with a short assessment of the corporate governance scenario at the end of the first decade of the new millennium, and raise

some issues that world economies in general and India in particular need to address in the decades ahead. Can we retain the undoubted benefits of having independent directors on boards albeit with the introduction of some valuable enablers that would help the system to deliver its promise? Can we rationalise our voting regimes in such a way that interested shareholders do not vote for themselves at shareholders' meetings but defer to the wishes of other shareholders who are negatively impacted by corporate proposals? Can we restore the dignity and credibility of the institution of independent audit such that it can serve its intended purpose of reporting and assuring shareholders on the legitimacy of corporate financial reporting? What can we do to ensure that our regulators not only lay down appropriate rules of the game but also monitor and discipline defaulters uniformly, without fear or favour? This compilation offers suggestions—some of which have been used elsewhere in the markets which we seem to hold in high esteem—in the hope that they would be taken up in the Indian context with the seriousness that they deserve.

One of the greatest evils of contrived corporate governance is its deleterious impact on society by thwarting competition and encouraging undeserved economic rent-seeking. Brandeis (1995) highlighted this when he exposed the perils of the "money trusts" which enabled a handful of bankers in the US to curb competition and control large financial and industrial empires to the great detriment of society at large. Chandrasekhar Krishnamurthy's paper explores the causal relationships between competition and governance, and concludes that (1) greater competition tends to show up in greater variations in standards of firm-level governance both within countries and among countries; (2) firms operating in a competitive environment need to display superior corporate governance quality in comparison to their peers in order to gain access to resources and to enhance their credibility; and (3) it is this tendency to increase relative corporate governance scores that drives the observed divergence. Corporate governance practices at the firm level do not improve dramatically unless the competitive environment in the country is strengthened. Moreover, it is unrealistic to expect significant improvements in corporate governance unless there are socially acceptable standards of

political governance and operational probity in the country as a whole; a silo approach to improving governance in the corporate sector is unlikely to achieve sustainable levels of success without matching (or perhaps even surpassing) levels of excellence in overall governance in the economy of which the corporate sector is but a subset.

In a political environment with an overbearing bias towards de-regulation or even no regulation (such as in the US in the late twentieth century), what should be the approach towards corporate governance? Chiranjib Sen and N. Balasubramanian review some of the historical developments bearing upon economic regulation in general and corporate governance regulatory regimes in particular, and conclude that a better alignment of self-regulation mechanisms with corporate governance would mutually reinforce their strengths, and provide a more sound institutional foundation for market systems. While the authors recommend that corporations should have the freedom to adopt a set of practices from a menu of recommended options and to explain deviations, they believe that the success of such an approach would largely depend on the maturity and strength of the capital markets and their players (including the companies themselves), supported of course by overall excellence in the governance of the state and its component sectors. Until such maturity becomes an accomplished fact, a certain measure of mandated regulation together with rigorous enforcement may be unavoidable. The paper also offers comments on regulatory overlaps and how best they could be addressed.

Jamie Allen's paper tracks the progress of corporate governance standards and practices in select Asian countries in recent years, and observes a marked improvement. There are of course gaps that are yet to be bridged—the quality of continuous disclosure, the prompt disclosure of material price-sensitive information, the quality of financial reporting and audit, the effectiveness of independent directors and boards, and the rights and responsibilities of shareholders. This valuable documentation which draws on a wealth of observed statistical data has the potential to be the basis for a pan-Asian charter of demands for action in the region, so as to bring the countries up to speed in their race to the top of the governance tables.

K. P. Krishnan, C. K. G. Nair, and Anupam Mitra dwell upon the apparent futility of an entirely legal-centric model of governance of corporations unless it is concomitantly accompanied by a sound ethical and moral framework for corporate behaviour. Keeping in mind the increasing imperative to care for a larger pool of stakeholders other than the shareholders, the authors call for a mechanism where public interest, voluntary as well as mandated self-regulation, and a regime of prescribed controls co-exist. While this prescription is likely to receive wide support, the proportions of the components in this heady mix will probably need to be crafted in a dynamic framework of consultation and moral suasion to avoid any mismatch between desired goals and achieved results over time.

The timely and stringent enforcement of regulations is key to any effort aimed at narrowing the gaps between desired goals and achieved results. This is nowhere more clinically brought out than in the case of corporate governance aspirations and experience in different countries; India is no exception. Vikramaditya Khanna examines the current state of corporate and securities law enforcement in India, and the economic theories of enforcement and their application in the context of India's corporate ownership structures, all set in the backdrop of the country's legal institutional realities. He finds that enforcement can be improved by developing early warning systems and reforming parts of the criminal law, with greater reliance on private enforcement through arbitration, stock exchange enforcement, etc. as observed in other large emerging markets, and with an increased focus on governance concerns unique to concentrated ownership situations. Wouldn't these selective and focused approaches make practical sense in a country like India where the judicial processes are notoriously delayed, and also help in conserving its undoubtedly limited resources which are possibly spread too thin currently?

A frequently asked question in all these deliberations is whether corporate governance does matter at all, and if in the ultimate analysis there is a strong business case for incurring the costs of good governance (Balasubramanian, 2010, pp.18–27). Researchers like MacAvoy and

Millstein (2003, pp. 43–65), Gompers, Ishii, and Metrick (2003, pp. 107–155), Bebchuk, Cohen, and Ferrell (2005), Bhagat and Bolton (2007), Selvaggi and Upton (2008), and Balasubramanian, Black, and Khanna (2008) have grappled with this issue. Alka Banerjee, Subir Gokarn, Manoranjan Pattanayak, and Sunil Sinha revisit this problem, anchoring their study on the governance scores obtained from S&P ESG India Index as proxy for firm-level governance quality. They find that better governed firms command higher market valuations, give higher returns on net worth and capital employed, and enjoy higher Price-Earnings Ratios and yields compared to less well governed firms. Although virtually all these findings are influenced by the criteria used for determining what good governance and good performance are, there seems to be little doubt overall that the markets do recognise and reward/punish corporations based on their perceived governance record.

If one were to identify the predominant learning from the global financial meltdown that brought the world economic order and discipline to their knees, nothing would stand out more starkly than the role of risk management in corporate governance (Kirkpatrick, 2009), and the indifference—unwitting or otherwise—with which most corporate boards dealt with the subject (or more correctly, how they failed to deal with it). Dipinder Randhawa highlights how—with the evolution of the shadow banking system based on securitisation and the absence of oversight in matters pertaining to risk management—risk exposure in the affected financial institutions escalated beyond control even when Basel II-mandated capital adequacy requirements were ostensibly being met. While the limited exposure of Indian banks to derivative securities arising from subprime loans in the US helped to contain losses and to limit contagion effects, such serendipitous protection may not always be available in the future as economic growth, innovative financing, and regulatory relaxations bring the Indian financial systems up to speed with the rest of the developed world. The paper specifically focuses on the importance of the boards' role in initiating and overseeing efficient enterprise risk management systems.

A fact which is often overlooked in comparative corporate governance discussions is the vital role of ownership and control structures. Curiously enough, concentrated ownership is both a blessing and a potential problem—it is one of the key internal mechanisms widely credited with mitigating agency-related executive problems, and yet it is also a fertile source for tunnelling and exploiting private benefits of control by the controlling shareholders. Jayati Sarkar highlights the specific features that could lead to potential governance problems, and discusses some possible countervailing solutions. She also finds that the ownership and control structures of Indian business groups are complex and opaque—characteristics which are conducive to minority shareholder expropriation—and that institutional and block shareholders have not been able to act as effective countermeasures in thwarting such unacceptable behaviour.

While most mandatory and voluntary governance practices are intended to protect and promote the interests of the corporation and its stakeholders, especially those shareholders not in operational control, it is not always clear whether the eventual beneficiaries do in fact actually gain from such measures. Rajesh Chakrabarti and Subrata Sarkar set out to check what the markets trust in an emerging market scenario. Drawing upon the Satyam episode, they identify two distinct "events", the first a shock about board ineffectiveness and the second the confessional exposure of transparency shortfalls compounded by accounting malpractice, and they demonstrate that board independence and size matter, the characteristics of independent director impact markets favourably, foreign (not domestic) institutional holdings have a salutary effect, and business groups suffer a large discount. These are important findings, and business groups would need to go that extra mile in order to differentiate themselves from others in matters of good governance, both in actual practice and through effective communication.

Irrespective of sound regulation, rigorous implementation, and widespread ethical pressures, the business world has had its share of scams and disasters with astounding regularity. Pratip Kar's paper explores

whether there are any discernible trends in corporations preceding their slide down the slippery slope towards infamy, and often total collapse. Like Altman's (1968) Z Score model for predicting bankruptcies, could we find a prescription that would predict potential governance and financial disasters? Studying the track record of three companies from different countries—Maxwell Corporation of the UK, Parmalat SpA of Italy, and Enron of the US—Kar finds some unusually common and consistent patterns—the principal protagonists in these marches of folly were the promoters or chief executives, who were high profile and competent, driving their companies through their rise and ultimately leading them to their downfall; the recurrent theme involved giving the stock market and the associated players and institutions (shareholders, media, and analysts) an illusion of wealth creation, protecting and promoting that illusion, only to descend into eventual financial oblivion. Powerful, arrogant, and charismatic chief executives, often with more than a little help from their competent and creative chief financial officers, did themselves and their companies in. Closer home, memories of the Satyam scandal reaffirm that these lethal prescriptions know no geographical boundaries.

In the middle of all these tales of ruin and recriminations, one is conscious of the pitiful voices of reason and values, frail exhortations for corporate responsibility and legitimate wealth creation accompanied by its equitable distribution, even while caring for the social and environmental concerns associated with the conduct of corporate business. These make interesting copy in corporate communications and public speeches but usually take a back seat when business decisions and profit opportunities come to the fore. And yet, the decade did see some conscientious if faltering advances in the field of corporate social responsibility (CSR). Richa Gautam makes the very important point that CSR as an isolated standalone initiative will not do, and that no real progress towards sustainable corporate growth would be possible until CSR principles and postulates get embedded in corporate decision-making processes. It is noteworthy that in 2009 the Ministry of Corporate Affairs had announced some guidelines for voluntary adoption by corporations and that the parliamentary Standing

Committee on Finance had recommended that some of these be included in the Companies legislation which is pending before parliament at the time of writing. While highlighting the importance of CSR as a desirable element of corporate behaviour is welcome, mandatory prescriptions are not the way ahead, as they are based on the incorrect assumption that the government knows best about everything relating to the corporate sector and its business. Milton Friedman would have rightly categorised such measures entailing monetary obligations as state taxation (on companies) through the back door! It is a fact that a handful of Indian companies are already practising good CSR practices; one could only hope for more to follow suit if India Inc is to fully realise its potential for global business excellence.

The paper by Sammy Medora and Ganesh Ramamurthy deals with reputational agents, whose role in ensuring adherence to the highest standards of corporate governance cannot be overemphasised. Independent audit (despite some high profile instances of failure) is among the most fundamental building blocks of good governance since it performs the onerous role of an informed, competent, and unbiased referee, positioned between principals (shareholders) and agents (boards and executive managements). Often much-maligned, misunderstood, and ill-rewarded, independent auditors nevertheless form the bulwark of any sound system of corporate business offering a reasonable degree of information credibility. Equally valuable in the overall scheme of good governance are the regulators who lay down the basic minimum standards of acceptable corporate behaviour and responsibility towards the absentee shareholders and other investors. The paper draws upon a wealth of research and experience to document the challenges faced by regulators, and offers valuable suggestions for improved regulatory performance. Taking into account some of the other reputation agents the authors discuss in this paper, one is tempted to state (with due acknowledgements to Winston Churchill) that never in the scheme of the corporate format of business have so many (shareholders and other stakeholders) owed so much to so few (reputational agents) endeavouring to provide a credible and orderly operating market environment.

This compilation is rounded off with two papers on the institution of independent directors, the first by Prithvi Haldea, and the second by Subrata Sarkar, each with a distinctly different approach. The burden of Haldea's theme is that the institution of independent directors as it is currently conceived cannot and has not delivered, and is an unnecessary and avoidable cost to corporations without any corresponding benefits which therefore does not deserve to be continued with. Sarkar on the other hand, even while agreeing that the perceived performance of the institution of independent directors has been unsatisfactory, seeks to explain some of the underlying factors that could be militating against better performance (using for this purpose the famous Milgram experiment (Milgram, 1974) on the leader-follower paradigm from the field of social psychology), and concludes that what is needed is not the abandonment of faith in the institution of independent directors but rather the strengthening of the board structure and the board procedures which can make independent directors an effective corporate governance mechanism. The imperative is to have an unaligned, unbiased, and undeterred set of directors who would fairly and objectively assist the corporation in its wealth creating objectives, and would ensure true and fair accounting and reporting to absentee shareholders and other investing public and would also ensure the equitable distribution of created wealth to its rightful owners with minimum leakage during the transmission process. Under these circumstances, the most challenging task before corporations and the regulators would be to find ways and means of mending (and not ending) the system of independent directors in India. The answer clearly does not lie in seeking state or other third-party intervention in the appointment of independent directors, as has been voiced in some quarters. There would be little point in treating the symptoms and leaving the underlying disease untouched. Some of the enablers described in the paper by N. Balasubramanian and Deepak M. Satwalekar in this volume might offer a good beginning.

This collection offers the experience and insights of authors from a wide spectrum of exposure and expertise—academics, bureaucrats, regulators, executives, and professionals—from an equally daunting

diversity of disciplines such as economics, finance, accounting, law, public policy, social sciences, and so on. This truly reflects the multi-disciplinary complexity of the challenges in governing corporations—whether in the sphere of directing, managing, regulating, disciplining, or delivering.

This volume of course lays no claims to having achieved any measure of exhaustive coverage. There are many other dimensions that would need to be considered and commented upon—strategy, environment, internal controls, communications, and ethics, just to mention a few. To those who would have liked to see more papers on these topics as they relate to corporate governance—as indeed we would have—one could only convey the hope that there would be other volumes to follow in the months and years ahead.

N. Balasubramanian & Deepak M. Satwalekar

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Contents

1. Corporate Governance: An Emerging Scenario
N. Balasubramanian, Deepak M. Satwalekar **1**

Part I : Conceptual & Regulatory

2. The Two Sides of the Governance Coin: Competition and Regulation
Chandrasekhar Krishnamurti **35**

3. Regulation in Corporate Governance and Elsewhere: The Inconclusive Debate
Chiranjib Sen, N. Balasubramanian **60**

4. Progress, Unfinished Business and the Rewards of Corporate Governance Reform in Asia
Jamie Allen **97**

5. Anatomy and Limitations of a Legal-Centric Approach to Corporate Governance
K.P. Krishnan, C.K.G. Nair, Anupam Mitra **119**

6. Enforcing Corporate Regulation: The Way Ahead
Vikramaditya Khanna **134**

Part II : Empirical & Experiential

7. Corporate Governance and Market Value: Preliminary Evidence from Indian Companies
Alka Banerjee, Subir Gokarn, Manoranjan Pattanayak, Sunil K. Sinha **166**

8. Risk Governance at Financial Institutions: Looking Ahead after the Sub-Prime Crisis
Dipinder S. Randhawa **179**

9. Ownership and Corporate Governance in Indian Firms
Jayati Sarkar **217**

10. Corporate Governance in an Emerging Market: What does the Market Trust?
Rajesh Chakrabarti, Subrata Sarkar **268**

11. Finding patterns in Governance Failures and Drawing Lessons
Pratip Kar **290**

12. Integrating CSR into the Corporate Governance Framework: The Current State of Indian Law and Signposts for the Way Ahead
Richa Gautam **311**

13. The Role of Reputation Agents in Corporate Governance
Sammy Medora, Ganesh Ramamurthy **336**

14. The Institution of Independent Directors: Does it Really Deliver?
Prithvi Haldea **367**

15. Strengthening the Institution of Independent Directors
Subrata Sarkar **389**

ABSTRACTS

Corporate Governance: An Emerging Scenario

N. Balasubramanian, Deepak M. Satwalekar

Beginning with a brief review of the major developments in the field of corporate governance especially during the last decade, this paper identifies some of the major challenges that hinder good corporate governance, which broadly fall under three groups—board independence and effectiveness, shareholder protection, and credible gate keeping. The authors offer major recommendations in each of these areas, such as introducing quorum requirements for board meetings that would ensure the presence and participation of a majority of independent directors; approving key decisions only if a majority of independent directors affirmatively vote in favour; accepting the mid-term resignations of directors only by shareholders to whom such directors are answerable; preventing shareholders from voting on those resolutions where they are beneficially impacted to the exclusion of other shareholders (at general meetings); separating the disciplinary function of professional bodies over their members from their other functions; enhancing audit fees according to perceived value rather than criteria such as time and effort (which are adopted currently); and ensuring not only basic mandates but also their compliance on pain of punitive action for breach, whether the defaulters are in the private or public sector (the last being the responsibility of market regulators). The implementation of these recommendations would help to strengthen India's standing as a desirable and acceptable investment destination.

The Two Sides of the Governance Coin: Competition and Regulation

Chandrasekhar Krishnamurti

The evidence from past research supports the view that better governance enables firms to access resources on favourable terms. Yet significant

differences continue to exist in the quality of corporate governance across firms and across countries. What explains the variation in firm-level corporate governance? Doidge, Karolyi and Stulz (2007) find substantiation for the view that a country's characteristics explain the variation in corporate governance much more than a firm's characteristics. This paper posits that competition and regulation constitute the two sides of the governance coin which together distil the importance of a country's characteristics. The paper examines the direct and interactive effects of competition and regulation on the level and variation of corporate governance using a cross-country sample drawn from fifteen countries.

Regulation in Corporate Governance and Elsewhere: The Continuing Debate

Chiranjib Sen, N. Balasubramanian

This paper traces in part the changes in the nature and extent of the regulatory role of the government over the years, and takes a look at some of the general principles which form the basis of regulation. We first review the market regulation scenario preceding and following the 2008 financial meltdown, and then turn to a consideration of the regulatory scenario in the corporate sector with particular reference to India. We conclude that a better alignment of self-regulation mechanisms with corporate governance would mutually reinforce their strengths, and would provide a more sound institutional foundation for market systems. Firms—alongside other actors such as industry associations, citizen groups, and professional societies—could develop appropriate regulatory rules within a transparent and accountable framework.

Progress, Unfinished Business, and the Rewards of Corporate Governance Reform in Asia

Jamie Allen

This paper documents the progress made in the Asian region on the corporate governance front, identifies the key areas where more work remains to

be done, and makes policy recommendations that would help to reduce investment risks and raise the quality of capital markets around the region. One noticeable area of weakness in the region is the quality of continuous disclosure—the prompt disclosure of material price-sensitive information. A second area of unfinished business is the issue of account preparation and audit quality. The third issue discussed in this paper is related to the effectiveness of the independent directors and boards in improving corporate governance and accountability. A discussion of the rights and responsibilities of shareholders concludes the paper.

Anatomy and Limitations of a Legal-Centric Approach to Corporate Governance

K. P. Krishnan, C. K. G. Nair, Anupam Mitra

Corporate governance (CG) has assumed greater significance following the global financial crisis of 2007. While there are considerable efforts to strengthen the legal foundations of the CG framework, the effectiveness and sustainability of a legal-centric approach to this legal-ethical issue is questionable. Moreover, in a disparate framework of corporate ownership and management structure as in the Indian context, there are practical difficulties in enforcing uniform standards across the board. Given these constraints, a practical CG framework has to rest on a high moral foundation with norms and values collaborating with and supporting the legal framework. In the absence of such norms and values, the failure of legal-centric endeavours such as the Sarbanes-Oxley Act (2002) is no surprise. For an effective framework governing the code of conduct of business entities in defining their responsibilities towards the larger stakeholders, a mechanism of escalating strategy needs to be adopted, where public interest, self-regulation, mandated self-regulation, and a system of controls co-exist.

Enforcement of Corporate Governance in India: Steps Forward

Vikramaditya Khanna

Considerable debate has surrounded (and continues to surround) the enforcement of corporate and securities laws in India, especially following the revelation of the Satyam fraud in 2009. Effective enforcement is considered to be vital for encouraging stock market development and improving firm value. This paper examines the current state of corporate and securities law enforcement in India, the economic theories of enforcement, and the application of these theories in light of the ownership structure of most Indian firms and India's institutional considerations in the legal sphere. The paper finds that: (1) government enforcement can be improved by developing early warning systems and reforming parts of the criminal law; (2) private enforcement (of which there is effectively none in India) needs to be enhanced by devising mechanisms that rely less on court adjudication (e.g. arbitration, stock exchange enforcement) as is the case in other large emerging markets; and (3) enforcement in India should focus on the governance concerns most likely to be prevalent in Indian firms, which are primarily controlled. More detailed recommendations for reform supplement these findings.

Corporate Governance and Market Value: Preliminary Evidence from Indian Companies

Alka Banerjee, Subir Gokarn, Manoranjan Pattanayak, Sunil K. Sinha

Although corporate governance (CG) has gained substantial ground in developed economies, it has begun to make an impact in emerging markets like India only recently. Corporate governance formally became a part of the regulatory framework for Indian listed companies with the introduction of Clause 49 of the Listing Agreement in February 2000. However very limited evidence exists concerning the impact of CG practices on firm-level performance or valuations in the Indian context. This study attempts to fill this gap. Our motivation is to explore the linkage between good

CG practices and firm value—we want to test whether firms with better corporate governance practices receive better market valuations. We used CG scores obtained from S&P ESG India Index as proxy for firm-level governance quality. Our results show a positive and significant relationship between CG scores and firm-level performance after having controlled for a number of firm-specific and time-specific factors. Better governed firms command a higher market valuation, and they are less leveraged and have higher interest coverage ratios. Further they give higher return on net worth and capital employed, and their profit margins are also relatively more stable. And finally their Price-Earnings Ratio (P/E) and yield are also higher when compared to firms whose CG score is lower.

Risk Governance at Financial Institutions: Life after the Subprime Crisis

Dipinder S. Randhawa

The subprime crisis underscored the critical importance of corporate governance for effective risk management. The evolution of the shadow banking system based on securitisation, and the absence of oversight in matters pertaining to risk management served to enhance risk exposure even when banks were ostensibly meeting Basel II-mandated capital adequacy requirements. The limited exposure of Indian banks to the derivative securities arising from subprime loans in the US helped contain losses and contagion effects. However as the Indian economy gathers momentum for economic growth, and the use of innovative financing mechanisms becomes more widespread, the measurement and monitoring of risk in banks will assume increasing importance. This paper examines the factors that impair effective risk management and the vital role that regulatory agencies and bank boards can play in ensuring that the interests of the regulatory authorities, bank management, and the shareholders are appropriately aligned. The paper specifically focuses on the importance of the role of the board of directors in deploying principles of enterprise risk management in financial institutions, and the complementary mechanisms that facilitate

effective oversight and monitoring of risk positions at financial institutions. Issues that are likely to assume importance as India enhances its engagement with the global financial system are also addressed.

Ownership and Corporate Governance in Indian Firms

Jayati Sarkar

The ownership and control structure of corporations largely determine the nature of the corporate governance problems that these corporations face. The institutional set-up which such corporations are embedded in also plays a significant role in this context. At the same time, ownership structure is one of the key internal governance mechanisms widely considered to mitigate governance problems both in widely-held firms and in those with concentrated ownership and control. This paper examines the ownership structure of listed private sector companies in India, and highlights the specific features that could lead to potential governance problems, and discusses their solutions. Additionally, the paper reviews the evidence on the relationship between ownership and firm performance, based on existing empirical studies in the Indian context. Among the major findings of the paper (based on ownership data for the period 2001–2006) are: (1) the dominance of concentrated ownership structures in India both among group-affiliated firms as well as standalones; (2) the pervasiveness and persistence of insider control; and (3) the inability of institutional shareholders to effectively act as a countervailing force against insiders. In addition, the ownership and control structures of business groups are found to be complex and opaque—characteristics which could lead to minority shareholder expropriation.

Corporate Governance in an Emerging Market: What does the Market Trust?

Rajesh Chakrabarti, Subrata Sarkar

The recent corporate governance scandal at (what was formerly known as) Satyam Computers Services Limited provides two major corporate

governance events with effects on firms across the board in India (and possibly other emerging market countries)—the first was a shock about board ineffectiveness while the second was related to issues of transparency and accounting malpractice. We analyse the cross-sectional variation in the stock price reactions to these two corporate governance shocks for Indian companies. We relate the firm-specific cumulative abnormal returns on the days that these two events occurred to different measures of corporate governance to find out the market perception of the validity of these measures. We show that with regard to board effectiveness: (1) board independence matters; (2) the *characteristics* of the independent directors have a favourable effect on market reaction; (3) institutional holdings have a salutary effect, but only for foreign institutions; (4) board size has a positive effect on market reaction; and (5) there is a large discount for companies belonging to business groups. For the second episode, none of the variables related to board or audit committee independence are significant, but indicators of the quality of the audit committee seem to matter. The discount of group companies becomes even more pronounced in this episode. These findings help us identify what variables among those identified by prior research are actually taken into account by investors in an emerging market to assess the corporate governance levels of companies, and the extent to which they affect valuation.

Looking for Patterns in Corporate Failures

Pratip Kar

This paper is about the failure of companies when they are confronted with critical governance matters. Studies of the more (in)famous corporate frauds in different countries over the years show that governance failures fall into identifiable patterns. Three such companies—Maxwell Corporation, Parmalat SpA, and Enron—are studied in detail, with a brief look at a few other companies, in order to find patterns which could help to establish a framework for governance. The principal protagonists in these marches of folly were the promoters of the companies. They gave

shape to the companies through their ideas, were instrumental in the rise of their companies, and ultimately were the reasons for the downfall of their companies. The paper shows how time and again, circumstances have followed a certain pattern, first giving the stock market and the institutions associated with it (the shareholders, the media, and the analysts) an illusion of wealth creation and protecting that illusion, only to descend into financial oblivion eventually.

Integrating CSR into the Corporate Governance Framework: The Current State of Indian Law and Signposts for the Way Ahead

Richa Gautam

Different forms and levels of corporate social responsibility (CSR) are practised by most of the large global and Indian corporates today. However, the CSR or sustainability department remains by and large separate from the key operational and governance structures of the organisation. For CSR to be truly integrated within the functioning of an organisation, at least some elements of CSR or environmental, social, and governance (ESG) responsibility must be embedded in an overarching framework with which corporates are familiar. Because of its reach across corporate departments and functional units, the corporate governance framework is one such framework that is suitable for the integration of certain key environmental and social concerns into the core functions of companies. This paper examines two corporate governance structures under Indian law: (1) the board and its responsibilities to stakeholders beyond shareholders; and (2) the disclosure and reporting framework, and the obligation of a company to disclose certain non-financial (or ESG) information. In addition to examining the current state of Indian corporate and securities law in this regard, the paper provides suggestions to policymakers (as well as corporates for voluntary adoption) for a truly integrated approach to corporate governance and CSR in these two areas.

The Role of Reputation Agents in Corporate Governance

Sammy Medora, Ganesh Ramamurthy

This paper offers insights into the responsibilities of reputation agents with respect to corporate governance. We focus on five specific reputation agents—independent auditors, regulators, internal auditors, credit rating agencies, and the media—and explain why they are more important than others in shaping the perceptions of Indian corporate entities in the context of corporate governance. This paper seeks to throw light on the key challenges that these reputation agents face, and suggests improvements that may help these particular reputation agents to enhance their personal and professional integrity. The conceptual framework of this paper is based on the principal-agent model of governance (Jensen & Meckling, 1976) and the stakeholder approach to corporate governance (Freeman, 1984). Some key improvements suggested in this paper include a combination of rules-based and principles-based governance systems, forensic audits for public companies, strategic positioning of the internal audit function, wider coverage of enterprise risk management (ERM) in rating methodologies, and self-regulated media governance.

The Institution of Independent Directors: Does it really Deliver?

Prithvi Haldea

The role and the responsibilities of independent directors, which have been under debate for several years, have now come into sharp focus following the failure of many high profile corporations around the world and the Satyam episode in India. Clause 49 of the Listing Agreement mandates the induction of independent directors on boards effective from 1 January, 2006. To understand the quality of independent directors, a new database www.directorsdatabase.com was launched to catalogue the detailed profiles of directors. This paper offers detailed analyses of board composition, director profiles, and other related descriptive statistics based on the data of 2461 companies available from this database (which constitute nearly 85% of the applicable companies). The paper highlights that a majority of the companies have complied with Clause 49 in letter rather than in spirit.

The paper also deals with some related issues impacting the functioning of these directors such as their appointment processes, their remuneration, multiple directorships, and the definition of the term "relatives". The paper establishes that independent directors in India are by and large more a myth than reality. The paper also rejects the emulation of international practices which are valid for widely-held companies and different cultures, and argue for a localised version of corporate governance suited to Indian environment, with a greater focus on compliance.

Strengthening the Institution of Independent Directors

Subrata Sarkar

Regulators and institutional investors are assigning an increasingly important role to the board of directors in general and independent directors in particular, in ensuring good governance of companies. Yet conventional wisdom and empirical evidence seem to suggest that independent directors are not effective monitors of inside management. This paper reviews the need to have an independent board, and illustrates how this need is heightened in the context of Asian corporations including India where business groups dominate the industrial landscape, and where powerful promoters often occupy important positions on the board. The paper then argues that the answer to the apparent dichotomy lies in the proper understanding of the empirical issues related to the measurement of the effectiveness of independent directors, the exact roles that independent directors are expected to play in firm governance, and the procedural issues that affect a board's functioning. The paper draws on the famous Milgram experiment from the field of social psychology to highlight the behavioural issues related to leader-follower interaction, and to show how this interaction is altered by a change of the environment in which the leaders and the followers operate. The regulations with respect to independent directors in India are critically reviewed. The paper concludes by arguing that what is needed is not the abandonment of faith in the institution of independent directors but rather the strengthening of the board structure and the board procedures which can make independent directors an effective corporate governance mechanism. Specific recommendations to this effect are provided for the Indian context.

1

Corporate Governance: An Emerging Scenario

N. Balasubramanian, Deepak M. Satwalekar

1. Introduction

As the country races towards the end of the first decade of the new millennium, it is perhaps appropriate to take stock of the events and developments during this period and to plan out an action agenda for the decade ahead. While such a stock-taking exercise could (and should) include several fronts that are of national importance, this review exclusively focuses on the governance of business enterprises in a corporate format, especially those whose securities are listed and publicly traded. Needless to say, most of the issues discussed and the recommendations made in this context are applicable to other entities (like unlisted public and private limited companies) and also to those using other organisational formats (such as cooperatives, trusts, and associations of persons) where those in operational control of such institutions owe some fiduciary obligations to others who are not so positioned.

Although the term *corporate governance* in its present connotation seems to have gained currency in recent times and has been strengthened with every major corporate misdemeanour or financial distress in the recent past, the concept itself is not new. Drawing upon the basic political and ethical principles which underline the responsibility of those in authority to others in their realm, business corporations have traditionally been required to discharge their trusteeship obligations to their constituents, and to act in their collective interest. Of course, from time to time, this

onerous responsibility has been flouted by those in authority, with abuses of their power for personal advantage and aggrandisement. The tyranny of the majority—and equally, of the minority—has also been observed in the field of public policy and administration. This has been, and continues to be, the case with the governance of the corporate sector as well. Minimising such unacceptable behaviour becomes an issue of major concern (given the improbability of totally prevention), and this is sought to be achieved by instituting countervailing systems and institutions to protect the liberty of the individual constituents (Mill, 1859), whether they are the citizens of a country or the shareholders of a corporation. Such systemic checks and balances manifest themselves in legislative and regulatory mandates but their efficacy is determined by the effectiveness of their application in practice through timely and rigorous enforcement.

We begin with a brief review of the major developments in the field of corporate governance in recent times, especially during the last decade. We then deal with some key issues in the effective achievement of good corporate governance goals, interspersing our discussion with a prescriptive list of desired action initiatives.

2. Recent Developments in Corporate Governance

Most of the governance requirements relating to corporations in India till the end of the twentieth century have all been essentially in the form of legislation. The Companies Act of 1956 is still the basic statute, although it has been amended several times over the years. This Act will soon be modified by a more modern and relevant legislation when the Companies Bill 2009 currently before the Indian parliament (at the time of writing) enters the statute book. The Standing Committee on Finance (2009–2010) has already reviewed and submitted its report on the Bill. This initiative is an important step forward in the process of corporate governance reforms. While a comprehensive critique of the Bill and the Standing Committee's report is beyond the scope of this paper, it is important to mention that several of the measures proposed with regard to the governance of corporations leave a lot to be desired;

in many cases, these proposed measures represent a retrograde slide back to the bureaucratic control and permits regime of the past. Clearly this is inconsistent with the general trends of progressive liberalisation that have been pursued by the government with substantial success over the past two decades. An extraordinarily heavy dependence on subordinate legislation—235 separate instances of "as may be prescribed" in the Bill provisions as has been rightly pointed out in the Standing Committee's report (2010, p. 20) and in earlier critiques like Balasubramanian (2004, pp. 6–7) among others—goes against the progressive view that matters of public policy should come largely under parliamentary review rather than being addressed by the bureaucracy.[1] The assumption that the government (and its bureaucracy) knows best and can successfully drive businesses from the backseat is an outdated concept that has been proved ineffective time and again. Rather than overseeing company performance in key areas of governance, the Bill seeks to retain decision-making powers within the purview of the government, with companies having to seek approval on a variety of matters including the size of their boards and the separation of the positions of board chairs and CEOs. The government, on the other hand, could have signalled a stronger message for good corporate governance by improving and updating governance practices and shareholder protection measures in public sector enterprises, which the private sector could have been encouraged to emulate.

The first formal documentation in recent times of desirable standards of corporate governance in the country was brought out by the Confederation of Indian Industry's report (CII, 1998). While it fell short of international standards and best practices (Balasubramanian, 1998), as a self-regulatory industry initiative it was unique and path breaking. Being recommendatory in nature, only a handful of its member companies ventured to adopt the measures suggested in it to usher in improvements in their governance.

This was followed by the recommendations of a Committee on Corporate Excellence (2000) headed by Sanjiva Reddy, secretary of the (then) Department of Company Affairs. Many of its recommendations—

such as restricting voting rights of interested shareholders at general meetings, empowering independent directors through quorum requirements, ensuring majority independent directors' presence at meetings and key resolutions having to be voted for by a majority of independent directors—were probably far ahead of their time.[2] Although these recommendations were broadly accepted in principle, and some were even implemented in phases including the one that eventually led to the formation of the National Foundation for Corporate Governance as a non-governmental body to promote corporate governance in the country, this committee and its report never received the attention and publicity that they deserved. As a result, this initiative has remained largely unnoticed, relegated to the archives of the Ministry of Corporate Affairs. Around the same time major regulatory reforms were ushered in by the Securities and Exchange Board of India (SEBI) through the introduction of the now famous clause 49 of the Stock Exchange Listing Agreements based on the recommendations of the Kumar Mangalam Birla Committee on Corporate Governance (1999). These were further refined and improved upon when the recommendations of the Narayana Murthy Committee (2006) were implemented, effective 2008.

There has thus been a crowded programme of legislative and regulatory reforms during this decade. Most of these efforts have been directed towards bringing the corporate governance standards in the country closer to internationally accepted levels of corporate conduct and responsibility. There would still be gaps inevitably, and one hopes that these would be addressed over time, so that India's standing as a desirable and acceptable investment destination gets further strengthened.

The greedy dimensions of corporate and human behaviour

While the country's record of legislative and regulatory improvement has been more than satisfactory, there have also been several instances of corporate misdemeanours during this decade. At the top of the list was the major fraud at Satyam Computers, the fourth largest Indian software services company (after TCS, Infosys, and Wipro). This fraud was perpetrated over a seven to eight year period during the decade by the

CEO,[3] who had until his confession in January 2009 enjoyed a very high personal reputation for integrity and model behaviour. This episode also brought out a rare display of institutional investor activism and resistance, where dubious corporate decisions that were seen as patently enriching those in operational control at the expense of other shareholders were disapproved. Regrettably, this disaster also showed board independence and oversight diligence in the most unfavourable light, especially since the company's star-studded board satisfied the most desirable prerequisites of ideal composition and structure. Another major casualty in this incident was the institution of independent audit, and the reputational credibility of even internationally well known audit firms. While damage control measures did indeed salvage the company and the image of the country thanks to some exemplary initiatives by the government and the industry itself, the scars of this mega scam will probably take a long time to fade away.

Among the other corporate and capital market scams were the Ketan Parekh heist in 2002 (along the lines of a similar fraud perpetrated by Harshad Mehta a decade earlier) where the Bank of India, Madhavpura Cooperative Bank and others lost billions of rupees, the insider trading scam involving the Monthly Income Plan investments in Unit Trust of India where scores of large business houses were able to foreclose their investments while millions of small unit holders were left to bear the losses, the phenomenon of disappearing companies on the stock exchanges after their public offers for subscription, the notorious Z list of companies of dubious credentials on the Bombay Stock Exchange, and so on. Much of the fraudulent and often irresponsible behaviour of the fraudsters was facilitated by lax controls and monitoring systems within the companies as well as in the operation of the regulatory systems.

What is discovered and publicised is often a fraction of what goes undetected. If India has not had corporate scams of the size and number many other countries have reported, it is probably due to our relatively poor monitoring and preemptive mechanisms. There is therefore little room for complacency on this account. We now turn to a consideration of

some key issues and impediments that bear upon ensuring good corporate governance.

3. Potential factors impairing good governance

In the large limited company format, there is virtually a complete separation of control from ownership, leading to principal-agent divergence of interests (Berle & Means, 1932); given this, there are obviously several inherent challenges to ensuring good corporate governance (Balasubramanian, 2009). These could be grouped under three broad heads—board independence and effectiveness, shareholder rights to protection from potential expropriation, and credible gate keeping and certification of disclosed information. The first subsumes themes like empowering director and board independence; the second includes issues like the ethics of exercising shareholder voting rights, board versus shareholder primacy (or the major shareholder versus the dispersed small shareholder primacy) , institutional investor activism, executive compensation, material related-party transactions, parent-subsidiary relationships, etc. The last essentially covers independent audit, governance and credit rating, corporate disciplining by regulatory bodies and stock exchanges, and so on.

From a general perspective of the country's image (an important consideration influencing direct investment flows) one should also explore good governance imperatives in business entities (many of which are large and systemically important) other than just the listed and publicly traded corporations. These would include banks and financial sector institutions, public sector enterprises, large but unlisted public and private companies, trusts and other forms of business organisation including cooperatives and joint ventures. The state of public and political governance in the country must underlie all these; it would be absurd to aspire for islands of excellence in terms of corporate governance without an equally vibrant, inclusive, transparent, and value-based governance structure at the level of the state and its public policy and service delivery systems. How can good governance be sought from corporations in isolation unless those in the

field of public policy formulation set an example by practising matching or even superior standards of governance?

On board independence and effectiveness

Empowering independence of boards and directors

There is a fairly strong academic and practitioner attitude of scepticism about the inherent reality and contributory potential of the institution of independent directors. High profile corporate scandals in the recent decades certainly seem to lend support (at least anecdotally) to the emerging view that the institution of independent directors is an unnecessary burden on the corporation without any significant benefits to the investors and the society at large. There is also enough evidence of independent directors being fair-weather-friends of companies, sticking with them during good times and deserting them at the first sign of impending disasters (Fahlenbrach et al., 2010, pp. 22–23) or immediately after corporate scams or punitive legal judgements as was witnessed after the Satyam episode in 2009 and the Union Carbide (Bhopal) verdict in 2010. However, given the soundness of the underlying principles of objective and non-aligned review and surveillance over executive management (whether by professional managers or controlling shareholders) that this institution is positioned to provide in the interests of all absentee shareholders, it may be useful to explore how the mechanism could be strengthened to achieve its intended purpose more effectively (Balasubramanian, 2009). This would involve a discussion of the definition of independence in this context, how such independent directors are appointed and compensated for their time and effort, how their collective voice should be provided with more teeth to be really effective, how the abuse of such vested power should be treated and penalised, how their tenure should be protected to ensure unbiased contribution, and what the attendant features of their exit or separation before their term should be; these issues are taken up in detail below.

Defining independence

Over the years, the criteria in India for ascertaining director independence have been refined and brought closer to international best

practice requirements, but there is still scope for further fine-tuning. Rather than mandating such requirements, laying down broad principles to be followed with a comply-or-explain caveat may be a more preferred option (Balasubramanian et al., 2006). This would ensure that the desired benchmarks are laid down giving the companies the option to follow them or deviate from them if deemed necessary as long as they provide suitable justifications to the shareholders, who can then make an informed assessment of the governance risks involved.

In a country like India where ownership structures are predominantly inclined towards concentrated holdings by promoters or groups (irrespective of whether they are domestic or family groups, MNCs or the state), the foremost criterion for determining the independence of an individual should be his/her association with not only the subject company but also the group entities and power centres as a whole. The present regulatory provisions do not seem to fully take this important fact into account. Whether or not an individual is a non-executive director in another entity controlled and/or owned by the same parent or some other entity or individual that is influenced by the subject company usually gets ignored when considering linkages with the promoter for the purpose of determining the individual's independence in the subject company (even though the remuneration received collectively from all such entities may be material to the individual). One should recall that it is only the remuneration received from the subject company as its director (and not from other connected entities) which is excluded in determining individual independence; this important aspect seems to be overlooked wittingly or unwittingly in most such cases.

Companies in India (and in a handful of other countries) have the practice of retaining on their boards non-executive directors who do not qualify as independent under the prescribed criteria. While this practice may have been a necessary transitional measure, it is perhaps time to phase this institution out over the next few years. One way of achieving this objective would be to lay down a progressively diminishing maximum proportion of the board that can be non-executive-non-independent. This

would also probably pave the way for the induction of more independent directors without unduly increasing the overall board size.

Appointment and remuneration of independent directors

Much of the criticism on the behavioural incapacity of independent directors to disagree with the promoters or management to whom they are beholden for their jobs is based on the fairly fundamental human reluctance to bite the hand that feeds them. It is probably for this underlying reason that international best practice calls for such selections and appointments to be made by a Nominations Committee which is wholly composed of independent directors. Indian regulation needs to move towards this practice sooner rather than later. Also, it would be appropriate for the appointment to be made in the name of the board and conveyed to the individual by the board chair together with at least one senior independent director, in order to reinforce the need for allegiance to the company and its shareholders rather than to the CEO or the executive chair in his/her personal capacity.

The matter of independent directors' compensation often leads to a discussion on whether an overly generous package—especially profit-based commissions and stock options—tends to erode director independence. There is merit in this argument, and it is heartening to note that the voluntary corporate governance guidelines of the Ministry of Corporate Affairs (MCA, 2009) suggest eschewing such methods of compensation. On the other hand, there are jurisdictions elsewhere (like the US and the UK) which actively encourage the allocation of some part of the compensation in the form of equity so as to better align the long-term interests of directors and shareholders. There are at least two potential pitfalls to guard against even while benefiting from such congruence of interests. The first is the possible temptation to embrace creative accounting and other devices to enhance company profits if the stock allocations are profit-based. The second and the more pernicious danger is the potential for insider trading—directors may be tempted to cash in on the privileged information available to them. The first can be tackled by a truly independent audit scrutiny, while the

latter can be contained through suitable restrictive covenants of holdings lock-in until the end of the directors' tenure.

The concept of materiality also needs to be interpreted more rigorously. If a director's independence is assumed to be under threat because of high compensation, then its materiality should be linked to the individual's income and wealth rather than to the size and earning of the company paying the compensation. This also highlights the possibility that the same remuneration for all the directors on a board may have different shades of materiality with respect to different members. One way of encouraging continuing independence in such cases may be for the chair and the other directors to reach out and seek the views of such members during board discussions, and to encourage free and open debate on issues so as to help such directors overcome any personal or behavioural problems that they may have.

Giving independence an effective voice

Even when board independence is well secured, there are inherent limitations in the current legislation and regulation that militate against effectively pursuing the collective independent view to its logical conclusion. Unlike the German model of duel boards where the executive management is separated from the supervisory board, the Anglo-Saxon single-board structure neutralises to an extent the effectiveness of the independent elements in the board, which more often than not is not a significant majority (since regulation does not mandate it). One way of overcoming this problem would be to ensure that the independent view is "enabled" to be heard and acted upon (Balasubramanian, 2009). Two key enablers are described below.

- Currently quorum requirements for board and committee meetings do not mandate the presence of any of the non-aligned directors. Theoretically, it would be possible to have a valid board meeting with only executive directors in attendance who approve important decisions, notwithstanding the presence/absence of the independent directors on the board. For the role of non-aligned

directors to be effective, it is important that board meetings necessarily require their presence or at least the presence of a majority of such directors at the meeting.

- Equally, it is important to mandate that certain key decisions on specific topics can be approved by the board only if a majority of the independent directors of the company in totality (and not just a majority of those present at the meeting) vote in support. This provision would ensure that the independent directors' opinions are heard and their votes count.

Two major concerns can legitimately be voiced against such special empowerment of independent directors—one is conceptual and the other practical. It could be pointed out that all directors are created equal, with similar fiduciary obligations and liabilities. Conferring special powers on some of them and enabling them to veto a majority of the other members of the board amounts to downgrading the others' importance and value to the company, and is patently unfair. This is apparently a strong argument for the equality of voting rights. However, equity demands that unequals be treated unequally—directors in executive capacities are performing the role of *agents* in the governance hierarchy, and to that extent their personal agenda can potentially be incongruent with the principals' agenda in terms of wealth creation for and distribution to the latter. Since one of the key responsibilities of the board is oversight and monitoring of the executive management, it would not be unfair to ensure that the non-aligned directors—who have been specifically inducted on to the boards in order to carry out such unbiased and independent evaluations and monitoring in the interests of shareholders—are in fact present and participating, and that a meeting without their full presence (or at least a majority of their presence) is disempowered to take critical decisions.

Additionally, it could be argued that such virtual "veto" powers in the hands of independent directors may be open to abuse and in extreme cases could also encourage some form of blackmailing or extortion. This is a valid point since power in any form is often an invitation to potential abuse, and after all, non-aligned directors are equally subject to human

failings. Keeping this vulnerability in view, our recommendation is for approvals by a majority of the independent directors and not by all such directors. It is highly improbable that independent directors would all get together to unreasonably withhold consent related to matters that are in the overall interests of the company. As a further measure of prudence and deterrence against such abuse of authority, it may be appropriate to set up a quasi-judicial, autonomous National Corporate Governance Authority (NCGA) for transparent peer review by expert panels of uninvolved, experienced directors, and other people of eminence, who would look at complaints of any such abuse of power by non-aligned directors. If abuse is proved, the guilty should be handed down the most stringent penalties including disgorgement of any personal gains with salutary penalties and debarment from directorship of any corporate entity where other people's monies and resources are involved. To ensure that the accused non-aligned directors also have a fair dispensation of justice, they should have a right of appeal to the highest court against the decisions of the NCGA. With these systemic checks and balances in place, it should be possible to allay fears of any abuse of these provisions.

Assured tenure and mid-term separations

For any person in authority to function without fear or favour, an assurance of a fixed tenure of office would function as a great source of motivation. It is desirable that independent directors are appointed for an assured term, of three years for example, during which he or she could be impeached and dismissed only on certain specified grounds and after following due processes. Current law in effect provides for a three-year term for most directors on the boards of companies since it requires one-third of the board (except certain executive positions) to retire by rotation each year, with no bar on re-election. What may be more meaningful in the context of board and director independence is to make the appointments independent director for assured fixed terms of three years each. Concomitantly, specific grounds and processes for mid-term dismissal must also be mandated. The grounds could include, for instance, continued absence from board and committee attendance, moral turpitude, criminal convictions even in cases

unconnected with the company, observed anti-company activities, etc. Such dismissals should be discussed and recommended for shareholder approval by a fully attended board with a majority of other independent directors voting, and the members at the general meeting should approve the recommendation of the board for such dismissals.

Of course, independent directors must be allowed the freedom to resign mid-term if they choose to do so, albeit with certain restrictions. The present practice (which is in compliance with law) is for the board to accept the resignation. This is conceptually incorrect. Theoretically, directors are elected by the members in a general meeting and they owe their fiduciary responsibility to the shareholders; unless otherwise authorised, they should submit their resignation to those who appointed them. Even more importantly, they owe it to the members to explain why they were resigning mid-term and to be personally present (unless circumstances prevent such a course of action) to answer any questions shareholders may have regarding their decision to resign. The standard explanations that the resignation was "for personal reasons" or "on health grounds" are for the most part patently frivolous and a travesty of justice as far as those who appointed these directors to act on their behalf are concerned. Most companies carry out exit interviews when even middle and junior level employees leave their jobs; do the shareholders deserve anything less when their elected directors decide to quit before their term?

On shareholder rights and responsibilities

The second set of challenges to improved governance stems from and is related to the principals themselves—the shareholders. Voltaire, the noted French philosopher, insightfully described why people agree to become citizens of civic and political communities even though such a decision may necessitate some sacrifice of individual freedom and subjection to the group discipline. The principal motivation, he reasoned, was the assurance of security and peaceful co-existence in pursuit of individual economic and other goals which may not be possible without such structural agglomeration into communities and nation states. The rationalisation for absentee shareholders investing in corporations is somewhat similar to

this—they may be well aware that they may not receive the full benefits that ought to flow to them as a result of successful business operations, but they are willing to make this sacrifice because they by themselves, with their limited resources and expertise, may not be able to initiate and sustain such business ventures. Having agreed to incorporate themselves into a body corporate (which is what the Memorandum of Association of companies signifies) and also having reconciled to delegating the task of overseeing and carrying on the business of the corporation to a body of elected representatives (which is what the board and directors are all about), should the principals be relegated to the position of helpless bystanders? Shouldn't there be a far more elegant framework than what currently exists, which would enable shareholders as a collective body to exercise their rights to determine broad guidelines as to how major and material aspects of the corporation's business—*their* business—should be run for the equitable benefit of all of them? To be meaningful, this would of course require a much higher level of application and engagement on the part of institutional and other block shareholders to enable them to discharge this responsibility effectively, but they owe it to their own constituencies whose monies they are deploying in the equities of the investee companies.

Board versus shareholder primacy

This then leads on to a discussion of the crucial issue of primacy in governing the corporation—is it the corporate board or the collective body of shareholders that is supreme? In the last decade and a half, the views expressed on this issue among legal scholars have been polarised (Bainbridge, 2005; Bebchuk, 2005, 2006; Strine, 2006) especially with reference to the corporate law in the US, more specifically in Delaware. It is well established that in the case of large public corporations, shareholders running into millions cannot possibly have a say in the operations of their companies, and that this task must be delegated to the board of directors and through them to executive management. But the question is: to what extent should and could shareholders have a voice in shaping not only the policies but also the people who will conceptualise and consummate

those policies? In some ways, the Indian position is way ahead of the US situation on many aspects of shareholder empowerment. For example, in India, shareholders elect their directors individually, not as a slate as in the US; shareholders vote on directorial remuneration unlike in the US where it is only in recent times that the "say-in-pay" movement has been gaining ground; there is a provision for electing a small shareholders' representative on the board in India, while there is no such provision in the US; there are postal ballot provisions on certain key issues with no corresponding provisions in the US; and there are express provisions on what the boards cannot do without shareholder approval in India, while similar limitations do not apply in the US. There are two major weaknesses in the Indian regime though—there is very little institutional investor activism and there is relatively poor implementation, monitoring and disciplining routines in practice; the US scores better on both these counts.

Shareholder power: A reality check

Although Indian law offers certain rights to the shareholders on some key matters of corporate policy and operation, in practice, their real value is largely circumscribed partly by shareholder apathy and more importantly by inherent design deficiencies in the suffrage systems which are in operation. While the indifference exhibited by a vast majority of small investors may be justified (since many of them may not have the time, inclination, expertise, or economic motivation to warrant greater attention), much greater involvement and contribution should be forthcoming from block holders and institutional investors. Even more importantly, such institutions—as responsible shareholders often with their own fiduciary obligations to their own constituents—need to play a proactive role in ensuring that the governance risks in their investee companies are minimised. More transparency in communicating their position and voting strategies on key resolutions of their investee companies is also required. On rare occasions (such as in the Satyam episode), institutional investor activism has indeed preempted the blatant abuse of corporate power, but there is a strong case for some kind of an organised structure (such as the Council of Institutional Investors in the US, or the International

Corporate Governance Network in the UK) to provide an ever-vigilant and well-informed shareholder review and resistance platform as a possible insurance against recurring corporate misdemeanours.

The second impediment to purposeful shareholder interventions has to do with the voting regimes in existence, and is a much more serious matter since it involves inherent voting biases that militate against the meaningful exercise of absentee shareholder power over corporate boards and managements. As the law has evolved over the decades, all shareholders within the same class or category are equal in their voting entitlements. While this principle is equitable and beyond question, problems may arise when some of the shareholders in the same class are negatively impacted by a decision while others may not be so impacted or may even benefit positively by the decision. In such circumstances, those who stand to benefit ought not to vote on such resolutions in the members' meetings. Related-party transactions involving matters such as group company mergers and divestitures, preferential share issues, setting up competing subsidiaries and other entities, transferring favourable corporate opportunities to other group companies or unfavourable opportunities from other group entities to the disadvantage of the other shareholders, and executive remuneration of shareholder managers are some of the issues that should attract such restraint on the part of interested or benefitting shareholders in general meetings. The boards in such situations may be ineffective in preventing such resolutions since the controlling shareholders could always have them approved at general meetings of members where they can vote their block of shares in favour of such resolutions.

Sweden (Pierce 2010, p. 622),[4] Singapore, and Hong Kong are some of the countries that have such provisions in place;[5] Balasubramanian (2010, pp. 305–309) discusses some of the other countries which have similar provisions. Overall, the restraints regime imposed on controlling and self-interested shareholders rests on the equity premise that those who are in management or directorial control of the corporations and those shareholders who stand to materially benefit from a self-interested

transaction—financially or otherwise—should seek and defer to the decision of the majority of the other (negatively impacted) shareholders.

There would be strong objections to the introduction of such provisions in Indian law or regulation as they would seriously compromise the sanguine complacency with which such resolutions could be pushed through under the present dispensation. A key argument that would be (and has been) advanced is that shareholders have no fiduciary obligations to other shareholders, and are entitled to vote their shares in their own best interest. But the position is materially different when it is the controlling shareholders (as directors) and the executive managements of companies that propose such resolutions in their own favour; in such circumstances, their fiduciary obligations to the company and to shareholders should take precedence over their own rights.

This wholly ethical and equitable principle has been upheld even in the most unlikely situations and circumstances. For example, it would be ironical to associate such sentiments with any of the ruthless capitalist pioneers who strode the US scene in its early decades of development (when even insider trading as it is known today was not frowned upon); but there seems to have been at least one recorded instance involving the nineteenth century colossus Vanderbilt, foremost among the robber barons of that era. On his death in January 1877, the directors of the several railroad companies that he had founded and nurtured issued a joint tribute which contained the following statement germane to our discussion (Stiles, 2009, p. 566):

> It is to his lasting honor that his uniform policy was to protect, develop, and improve the interests with which he was connected, instead of seeking a selfish and dishonorable profit through their detriment and sacrifice. The rights and welfare of the smallest stockholder were as well guarded as his own... .

Recommendations to introduce the concept of "interested shareholders" and to enforce restrictions on their voting rights on those

resolutions benefitting them to the exclusion of other shareholders had in fact been made by the committee on corporate excellence through governance (2000); however, Indian legislation and regulation are yet to implement these recommendations. On the basis of a further representation, the Irani Committee (2005, para 35) did indeed refer to this issue as follows, but stopped short of recommending legislation on grounds that there could be practical difficulties in implementation.

> The Committee considered the concept of exclusion of interested shareholders from participation in the General Meeting in events of conflict of interest. The Committee felt that this was an aspect of good Corporate Governance which may be adopted by companies on voluntary basis by making a provision in the Articles of Association of the company. In view of the issues related with enforcing compliance of such requirements, there need not be any specific legal provision for the purpose.

The standing committee on finance has also not commented upon or recommended any legislative changes in the Bill pending before parliament (at the time of writing). Unfortunately, a great opportunity to introduce a path breaking reform thus seems to have been lost at least for the time being. Can our politicians—in their role as conscience keepers of the nation—revisit this key issue when the Bill comes up for discussion in parliament and bring about this change? Without such an equitable and elementary preemption, all endeavours to protect minority or absentee shareholder interests would remain well-intentioned sentiments on paper with little or no practical application or relevance.

Executive compensation

Among the issues related to corporate behaviour that have generated animated debate in recent years is the subject of executive compensation. The global financial meltdown in 2008–2009 and the heavy price that countries around the world had to pay to restore a semblance of normalcy have further exacerbated this already sensitive issue of what is considered

as unbridled greed on the part of executive management, especially in the financial sector.[6] Regulatory interventions—that would have been previously unthinkable in open market economies like the US and the UK—have been witnessed, although an apparently unrepentant private business seems to be carrying on regardless of all this.[7]

India has a history of government intervention in managerial remuneration, although more on the grounds of public policy interest dictated by political (i.e. socialist) considerations in the latter half of the twentieth century. The limitations placed on the corporate sector pay in India were so unrealistic that there was an increasing tendency to resort to off-the-record methods for compensating executive directors. Thankfully, most of such draconian rules are a thing of the past, although some of the excesses observed in the Indian corporate sector—further prompted by moves to curb excessive remuneration practices in the West—clearly portend an unwelcome return to the regulatory regimes of the past.

In discussing executive compensation reforms in the Indian context, it is important to bear in mind the following key aspects. Unlike in the US where the compensation committee and the board determine and approve executive remuneration packages (even the current "say-in-pay" moves speak only of non-binding shareholder interventions), in India the remuneration packages of directors have to be individually "approved" by the shareholders in a general meeting. This is an important distinction, even though Indian general meetings of shareholders are not wholly effective for discussing and making informed decisions related to such issues (as was noted earlier). As a result of this divergence, while the compensation committees in the US have only to satisfy themselves that what they are approving is the right package under the circumstances, in India the compensation committee is obligated to go that extra mile to explain and convince their shareholders that what they recommend is in fact the best for the company in terms of its value-creating imperatives. The board report, explanatory statements to the resolutions, compensation discussion and analysis, or whatever else is required to be presented to the shareholders must meet this fundamental objective.

Share ownership of corporate India is predominantly skewed towards concentrated holdings by domestic and family groups, multinationals, and the state, unlike in the US and the UK. Very often, executive compensation packages that come up to the members for approval pertain to those dominant share owners themselves or their representatives, which makes them similar to related-party transactions between the companies and their controlling owners/managers. In such cases, the controlling owners and managers should refrain from voting on resolutions relating to their or their representatives' compensation (as was discussed earlier). It should be left to the board, its compensation committees, and those shareholders without any interest at stake to take a call and to approve or reject such compensation packages. (And if the unrelated shareholders especially of the institutional variety do not apply their mind and vote on such resolutions, they should have no complaints later that executive compensation especially that of companies was excessive or unreasonable. In fact, their own constituents should question such institutional investors regarding how they justify their decisions to approve or abstain from such resolutions.)

The members of the compensation committee owe it to themselves and to their shareholders to exercise proper due diligence in satisfying themselves that the proposals they are approving or recommending for shareholder approval would stand the test of sound reason and business logic. Writing several years ago, Jensen and Murphy (2004, p. 51) had this salutary counsel to offer to members of the compensation committees.[8]

> Remuneration committees must take full control of the remuneration process, policies, and practices. In particular remuneration committees should jealously guard their initiation rights over executive remuneration. They must abandon the role of simply ratifying management's remuneration initiatives. Obviously [this] does not mean that committees should make decisions and recommendations to the whole board without discussions with management, but this is quite different from allowing management to *de facto* seize the remuneration initiation rights. Remuneration

> committees can ask for data or information from corporate human resource officers, but these officers should report directly to the committee (and not to top management) for committee related assignments.

Often, references are made to international compensation levels to justify the proposed compensation packages. Such arguments are specious and meaningless since many other aspects of the Indian corporate scenario including earnings at other levels, product/service pricing and quality, input costs, general employment and income levels of people in the communities where the companies operate, etc cannot be compared to their international equivalents.

On gate keeping and regulatory discipline

The third group of issues that calls for attention is related to the importance and credibility of reputational agents whose primary purpose is to evolve a societally acceptable set of rules of the game and to ensure that the participants play by those rules, on pain of punishment for violation. Besides the state and its executive and judicial branches (a discussion of which is beyond the scope of this paper), there are at least two important reputational agencies whose role in ensuring good corporate governance in a country is paramount—the independent auditors and the regulators (including stock exchanges). We confine our discussion here to a brief analysis of the directions in which these agencies could strengthen the good governance movement in the country.

Independent audit

An indispensible component of good governance and an inevitable institution inherent in the principal-agent equation of the corporate format, independent audit has long been at the centre of controversy and at the receiving end of constant criticism. More than a decade ago researchers had asserted the impossibility of auditor independence based on psychological experiments (Bazerman et al., 1997, pp. 89–94).[9] Further compounding and clouding this complex relationship are apparently innocuous initiatives such as shareholders leaving audit remuneration to be fixed by the board

or audit committee (which eventually translates to decisions being made by executive management), and independent auditor's close operational proximity and socialisation with executive management rather than an amorphous body of shareholders. Practices such as management letters pointing out errors and inadequacies to the management rather than to the board or audit committees let alone to shareholders also establish a relatively private and confidential relationship between executive management and the auditors, which is certainly not conducive to a strict arms-length relationship between the auditor and the auditee.

Research evidence also shows that audit qualifications do not have any major impact on the recipient shareholders—partly because of the delay in publication of these audit qualifications in the annual reports (by which time most of the investors are presumably aware of the problems anyway), and partly because of their perceived low-level importance in affecting a company's wealth-creating potential. This indifference on the part of the investing public (especially institutional shareholders) also leads to a false sense of complacency on the part of auditors that their reports do not materially add value to the shareholders, and hence misinformation either due to indifference, negligence, or in more serious cases even collusion are unlikely to impact them adversely.

While regulators around the world have tried to neutralise some of these deficiencies by various measures—auditor independence rules, peer reviews, regulatory oversight boards, and in extreme cases even punitive consequences—their perceived impact does not seem to have materially improved the overall impression of the institution of independent audit in terms of either its expected contribution or its achieved track record.
The following reforms concerning independent audit and auditors would be of special interest to India.

- At present in theory, any practising chartered accountant can be appointed to audit companies irrespective of their size or the auditor's own practical experience and bandwidth. It may be appropriate to initiate some regulatory measures that would restrict audits of at least

large companies (for example all listed companies) to audit firms of some prescribed size, experience, and expertise. This would be similar to the SEC practice firms of accountants in the US. This might sound as a restriction of the potential role of a large number of accountants in practice, but in the long run such a measure might actually lead to the creation of medium-to-large sized firms of accountants. This would also ensure that the investing public is provided with a specially created pool of independent auditors whose reputational contributions would be found more credible.

- The disciplinary functions of the profession are best separated from the training, certifying, and supporting dimensions of professional development. Self-regulation, as is often observed, generally degenerates into no-regulation. An independent quasi-judicial entity entrusted with the task of prosecuting and punishing the guilty may well take the overall rating of the profession to a higher level.
- Very often, professional accountants appointed to audit a company's financials tend to take the task as an entry point to seek potential further business from other group companies. Audit fees are usually quite low. Company boards and shareholders are mostly responsible for this sorry state of affairs. In a large number of cases, the fees are worked out on the basis of work-hours spent on the job. It is high time that Indian corporations and shareholders began recognising audit certification for what it is—an independent service assuring absentee principals that executive management had deployed their resources as mandated, duly accounted for them, and faithfully reported back to the principals—and began compensating the auditors adequately for their services. An appropriate value-based fee structure for company audits determined by the board/audit committees on behalf of the shareholders would go a long way in not only attracting and encouraging best talent to the profession but also generally raising the value-perception of the reputational contribution that this valuable institution makes to minimise governance risks to the investors.

- A great deal has been written about the perceived and the actual independence of auditors as a determinant of their credibility and effectiveness. As in the case of independent directors, audit independence is also a matter of individual character and upbringing. As far as the pecuniary aspects of audit independence are concerned, most regulations and guidelines seem to take an insulated view of the audit firm by itself and its earnings from and business connections with the auditee company and its related entities. ("Group" is often the loosely used expression to denote these agglomerations since precise definitions are not easy to come by.) What may be of greater importance is the position of the audit firm in relation to its own "group" of associates and affiliates. It is necessary to capture some of the nuances involved in the professional groupings of firms, and how their interrelationships may be a factor in determining audit independence. For instance, it is not unusual for an international firm of accountants to have an international group of companies as its audit and consulting clients for different parts of that group. Although the Indian audit firm by its very constitution may be an independent entity, its independence in relation to the Indian subsidiary of the international group is likely to be influenced by the value of the international business from the group to the audit firm's international parents or associates. The extent to which the local audit firm and its signing partner would be insulated from their own internal pressures relative to the Indian client subsidiary's financials is something that one has to reckon with. Most of the Big Four audit firm practices around the world, with their focus on international client bases, are likely to suffer from this inherent networking disadvantage.[10] The manner in which companies, audit committees, and regulatory and professional bodies need to tackle these issues related to audit independence is a subject that needs to be studied and deliberated upon in great detail.

Role of regulatory bodies and stock exchanges in corporate disciplining

The imperatives of the rule of law in any civilised society can never be overemphasised. In an ideal society where everyone knows and abides

by what is right behaviour, there would be little need for a code of do's and don'ts, much less for a punitive mechanism or *danda neeti* as described in the Indian scriptural tradition, to enforce the regulation. Since our society is not in that utopian state, and since both the *visible and invisible hands* of people drive them towards maximising their own interests even at the expense of others, there is a pressing compulsion to ensure not only that appropriate regulations exist but also that they are enforced in an effective and timely manner.

In pursuit of the investor protection objective which most capital market regulators embrace, what should be the key role of an organisation such as the Securities and Exchange Board of India (SEBI) in matters of corporate governance at listed companies? Mary Schapiro (2010, p. 3), the chairperson of the US Securities and Exchange Commission (SEC), was clear that:

> [T]he SEC's job is not to define for the market what constitutes "good" or "bad" governance, in a one-size-fits-all approach. Rather, the Commission's job is to ensure that our rules support effective communication and accountability among the triad of governance participants: shareholders, as the owners of the company; directors, whom the owners elect to oversee management; and executives, who manage the company day-to-day.

The notion of "investor protection" has often assumed a larger than life meaning in discussions in an attempt to cover every possible downside experienced by investors. Obviously this is not what investor protection is intended to connote. It is intended to ensure that the investors have full and fair communication of all relevant information in a timely manner that would help them to make well-informed decisions; it certainly would not extend to underwriting any equity risks related to business downturns, and so on. The rule-making role of the regulator and concomitantly its enforcement role thus assume great importance, since there is no greater inducement or encouragement for flouting prescribed rules than the sight of defaulters merrily carrying on regardless of their breach.

It is in this context that SEBI, the Indian regulator, may have to review and step up as necessary its disciplining role and performance. There has to be an even-handed treatment of listed companies in matters of compliance defaults, whether they are in the public sector or in the private sector. For example, it took a very long time for the regulator to question those companies that defaulted on the induction of the prescribed number of independent directors on their boards. Even when SEBI eventually did take up this matter, it was not pursued to its logical conclusion in the case of some of the listed public sector companies (such as the Indian Oil Corporation) where the boards pleaded that it was not in their domain to fill up such positions of independent directors.[11] Shouldn't SEBI, as the guardian of investors and the final arbiter for enforcing its own rules, have the authority to proceed against those in the government who are responsible for making such appointments in time? How else can the interests of the non-government shareholders, in the Indian Oil Corporation Limited for instance, be protected on par with similar shareholders in other listed companies? The larger question that arises under these circumstances is whether SEBI and the stock exchanges should agree to list such companies at all, when it is clear that their boards are disabled from performing some of the essential governance functions in the interests of shareholders.

More instances of such glaring inequities have come to light in the years since good governance rules have been in force, especially in the case of state-owned corporations. For example, in the case of public sector banks that are listed, the annual accounts and directors' reports are tabled at shareholders' meetings for discussion and noting, not for their approval. Such a vital right of shareholders has been completely ignored without the stock exchanges or SEBI taking up the issue with the government for enacting appropriate changes in law. In the absence of such proactive initiatives, the enforcement role of the regulator and stock exchanges would remain not wholly fulfilled. It is also the responsibility of the government—as responsible shareholders—to take stock of the situation and to initiate the steps necessary to restore confidence that its commitment to good corporate governance is fulfilled in letter and spirit, providing a role model that the private sector companies can look up to.

Can stock exchanges contribute to improved corporate governance practices among their listed entities? Stock exchanges historically seem to have been content with falling in line with the requirements "prescribed" either by the government or the capital markets regulator, at least in India. Progressive stock exchanges should go farther than this. Nothing prevents them from laying down listing regulations that improve upon the minimum requirements laid down by the regulator. At the end of the day, stock exchanges also have to build their own reputation to such an extent that being listed on them would be seen as adding reputational value to the companies seeking such a listing. Stricter listing norms would tend to be seen as minimising the governance risks involved in the companies and as such the value of the exchange itself could register favourable gains. There may thus be a good business case for the better stock exchanges to seek and establish unique differentiating points that would stand their valuations in good stead.

4. Summing up

This then is a brief and by no means exhaustive assessment of the corporate governance scenario as we head towards the next decade; the key prescriptions and recommendations for action detailed in this discussion are summarised below.

Key prescriptions and recommendations

On board independence and effectiveness

- Take due note of a director's association not only with the subject company but with the group entities and related power centres as a whole for purposes of remuneration, in order to determine his/her independence.
- Lay down a progressively diminishing maximum proportion of the board that can be non-executive-non-independent, to pave the way for enhanced board independence.
- Make the communication of the appointment as directors in the name of the board and convey the same to the individual

by the board chair and at least one senior independent director to reinforce allegiance to the company and its shareholders rather than to the CEO or the executive chair in his/her personal capacity.

- Encourage some part of the compensation in the form of equity so as to better align the long term interests of directors and shareholders; lock-in such allocations for the duration of the director's tenure and prohibit trading in such shares during incumbency.
- Materiality of director's compensation should be linked to the individual's income and wealth rather than to the size and earnings of the company.
- Quorum requirements must include the presence of a majority of independent directors on the board and key decisions on specified topics must require the affirmative vote of a majority of the independent directors on the board in totality (and not only of those present at the meeting).
- Set up a quasi-judicial, autonomous National Corporate Governance Authority (NCGA) for transparent peer review by expert panels of uninvolved, experienced directors and other people of eminence, to look at complaints of abuse of power by non-aligned independent directors.
- Appoint independent directors for assured three-year terms; concomitantly, lay down specific ground rules and processes for mid-term dismissal on grounds such as continued absence from board and committee attendance, moral turpitude, criminal convictions even in cases unconnected with the company, observed anti-company activities, etc.
- If resigning mid-term, independent directors should submit their resignations to the shareholders who appointed them. Directors owe it to their members to explain why they were resigning mid-

term and to be personally present (unless circumstances prevent such a course of action) to answer any questions the shareholders may have regarding their resignation.

On shareholder rights and responsibilities

- Greater involvement and contribution should be forthcoming from block holders and institutional investors.
- Institutional investors should transparently communicate to their constituencies their position and voting strategies on key resolutions of their investee companies.
- Some organised structure along the lines of the Council of Institutional Investors in the US or the International Corporate Governance Network in the UK should be considered in order to provide an ever-vigilant and well-informed shareholder review and resistance platform as a possible insurance against recurring corporate misdemeanours.
- When some of the shareholders in the same class are negatively impacted by a decision while others may not be so impacted or may even benefit positively by the decision, mandate that those interested shareholders who stand to benefit do not vote on such resolutions in the members' meetings.
- The compensation committee should be obligated to explain and convince their shareholders that what they recommend as remuneration for managing and executive directors is in the best interests of the company in terms of its value-creating potential.
- Controlling owners and managers should refrain from voting on resolutions relating to their or their representatives' compensation. It should be up to the board, its compensation committees and those shareholders without any interest at stake to decide on such compensation packages.

On gate keeping and regulatory discipline

- Shareholders should not leave the matter of auditors' remuneration to be fixed by the board or audit committee. Practices such as management letters pointing out errors and inadequacies should be addressed to the board/audit committee rather than to executive management. Institutional investors should seriously take up any adverse audit comments and reservations to prevent auditors from being lulled into a false sense of complacency that their reports do not matter to the shareholders, which would then lead to misinformation due to indifference or negligence.
- Self-regulatory measures should be initiated by the profession which would restrict the audits of at least listed companies to audit firms of some prescribed size, experience and expertise.
- Disciplinary functions of the profession may be separated from the training, certifying, and supporting dimensions of professional development.
- Boards/audit committees to determine audit fees based on the value of audit certification rather than on the time spent and costs incurred. For purposes of determining audit independence, the position of the audit firm in relation to its own "group" of associates and affiliates should be considered, domestically as well as internationally, with respect to the importance of the company overall. Ensure that appropriate regulations not only exist but are also enforced in an effective and timely manner.
- Ensure identical treatment of listed companies in matters of compliance defaults, whether they are large or small, in the public sector or in the private sector.
- Stock exchanges should not list those companies where it is clear that their boards are disabled from performing some of the essential governance functions relevant to the protection of minority or absentee shareholders.

- The government should set an example by implementing in letter and spirit best practices in governance in their public sector enterprises.
- Stock exchanges should lay down tougher listing regulations on corporate governance that improve upon the minimum requirements laid down by the regulator.

It is time the country geared up to strengthen its governance practices so as to induce much greater confidence among investors. Some of the directions for change and improvement have been indicated in this paper. Much more of course remains to be done. There are many more miles to go before the country could rest on its laurels of past achievements in this field, significant as they have been by any standards.

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Notes

[1] Incidentally, this is the view that both the Parliament and the Executive in the UK expressed regarding subordinate legislation relating to company law in that country. See Annex A & B (concerning Restatement Powers and Reform Powers respectively) in *Company law: Flexibility and accessibility – A consultative document,* (May 2004), and the House of Commons Trade and Industry Committee's Ninth Report of Session 2003–04, (September 2004) commenting on the *Consultative document* (2004).

[2] A summary of the report and its recommendations are available in Balasubramanian (2010, pp. 567–588).

[3] Vineet Nayyar, Chairman of Mahindra Satyam—the successor company after Mahindra successfully bid and took over Satyam Computers in 2009—believes that this fraud probably had its origins much earlier, maybe in 1992–1994. For details, see Mishra (2010, p. 6).

[4] There is a general rule in Sweden that the shareholders' meeting may not make a decision that might give undue advantage to some shareholders (or to third parties), to the disadvantage of the company or other shareholders. France requires unanimity of votes at a members' meeting in case of some fundamental decisions (Pierce, 2000, p. 232).

[5] Two judicial observations cited in the Hong Kong committee report on company law reforms (Hong Kong, 2000) are worthy of recall in this context:

> [T]he result of counting votes of the interested directors is to render the consent process useless in those cases in which the directors are able to affect the outcome. It becomes a pointless formality, inevitably producing the same result as the original board decision. Instead of the directors being required to satisfy an independent body within the company that the transaction is fair, the onus is thrown back onto an objecting shareholder to demonstrate to the court that it is unfair, the problems associated with which the fiduciary principle is expressly designed to avoid.
>
> (From: Parkinson, 1993, p. 216.)

> Ordinarily the director speaks for and determines the policy of the corporation. When the majority of stockholders do this, they are, for the moment, the corporation. Unless the majority in such case[s] are to be regarded as owing a duty to the minority such is owed by the directors to all, then the minority are in a situation that exposes them to the grossest of frauds.
>
> (From: *Greene Vs Dunhill International, Inc*, 249 A 2d 427 at 432 – Del.Ch.1968.)

[6] For a contrary view which maintains that financial sector compensations have largely been no worse but in fact have been the same or even better than compensations in the non-financial sector, see Adams (2009).

[7] The 2010 provisions of the Dodd-Frank financial sector reforms legislation and the earlier SEC requirements for a Compensation Discussion and Analysis report in the US, and the Walker Report recommendations in the UK are illustrative of the increasing governmental interventions in corporate executive compensation issues.

[8] Jensen and Murphy (2004) had a total of 38 such recommendations to offer in this paper, most of which are still very relevant internationally and most appropriate to Indian circumstances. Among them are an admonition to eschew the use of compensation consultants, and if unavoidable, to ensure they are appointed by and report to the committee rather than to executive management; they also highlight the imperative to change the structural, social, and psychological environment of the board so that the directors do not see themselves as obligated to or effectively employed by the CEO.

[9] Among the reasons supporting this conclusion was the finding that people tend to be less concerned about harming a statistical victim (remote population of shareholders) than a known victim (identifiable executive management). Other factors that were taken into consideration were the immediate adverse consequences of a negative opinion on an audit (possible loss of contract or employment); long-standing relationships with the companies under audit (familiarity); lax reporting standards and monitoring; and easy rationalisation of trade-offs (people at large may not actually be affected by misinformation, and hence it does not matter).

[10] The virtual disowning of the local firm and concerned partners by the global firm management in the Satyam episode opens up an interesting question as to whether the HQ approach would have been different had it been the Indian outfit of an international client instead of an isolated Indian client like Satyam.

[11] See Order under section 23 I of Securities Contracts (Regulation) Act, 1956, read in conjunction with Rule 4 of Securities Contracts (Regulation) (Procedure for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules, 2005, in the context of the Adjudication Proceedings against Indian Oil Corporation Limited. Adjudication Order No. BS/AO-60/2008, dated 27 October, 2008.

2

The Two Sides of the Governance Coin: Competition and Regulation

Chandrasekhar Krishnamurti

1. Introduction

Corporate governance has been defined by Daily et al. ("Corporate governance", 2003) as "the determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in the organizations" (p. 371). Ostensibly, the goal of a firm in deploying its governance is to mitigate the agency conflicts among the various stakeholders, thereby enhancing the overall performance. One of the fundamental tenets of neoclassical economics posits that a firm which operates in a competitive product market and meets its capital requirements in an efficient capital market should maximise the welfare of its owners and its customers. But in the real world, the results are not that straightforward. In the words of Prowse (1996):

> Creditors want to be sure that they will be repaid, which often means firms taking on less risky projects…managers would rather maximize benefits to themselves [by] preferring policies that justify paying themselves a higher salary, or divert company resources for their personal benefit or simply refuse to give up their jobs in the face of poor profit performance… Large shareholders with a controlling interest in the firm would, if they could, increase their returns at the expense of minority shareholders.
>
> (Prowse, 1996, p. 3)

There are significant costs that arise from the divergence of the interests of the different agents. Corporate governance is the product of the relationships and interactions between these agents. An optimal corporate governance structure is one that minimises the institutional costs that arise from the conflicts of these divergent interests. These costs can be dichotomised into two sources—the complex web of agency relationships that currently define large corporations, and the impossibility of writing complete contracts between principals and agents in order to eliminate such costs. Thus, Hart (1995) characterises a governance structure as "a mechanism for making decisions that have not been specified by contract" (p. 680).

A large volume of recent research has concentrated on two critical factors related to corporate governance obtaining at the firm level. The impact of a country-level regulatory environment on the companies has been the focus of a large body of research pioneered by La Porta et al. (1998). The impact of firm-level governance on performance has also garnered considerable research attention. We posit that in addition to the regulatory atmosphere, the competitive economic environment in which a firm operates is a key determinant of firm-level corporate governance. Surprisingly, the impacts of competitive pressures as well as the interactive effects of regulatory pressures and competitive forces on a firm's corporate governance practices have not received adequate research attention. In this paper, this lacuna is addressed by drawing upon the results of a cross-country empirical study involving firms from 15 emerging markets.

Corporate governance is deemed important due to its perceived impact on a firm's performance and due to its role in mitigating conflicts between the various stakeholders. In the context of performance, the empirical evidence available to date regarding the impact of corporate governance is mixed. We argue that this tenuous link between corporate governance and performance is due to the competitive economic environment in which a firm operates. We posit that there are four major factors determining the economic performance of a firm. The external governance environment in which a firm operates is a major determinant of the firm's performance.

This is often referred to as the legal or regulatory environment. The second factor is the internal governance of the firm. This factor pertains to the rules and stipulations that a firm has agreed to follow in conducting its business operations, and encompasses all types of stakeholders. The third factor that has a bearing on a firm's performance is managerial actions. There are both positive and negative managerial actions that could affect a firm's performance. Managerial slack, shirking, overconsumption of perquisites, and commitment of fraud constitute some of the negative ones. Positive managerial actions include optimal investment, financing, and risk management activities. Finally, the competitive economic environment has a bearing on a firm's economic performance. Our major focus in this paper is on a firm's internal governance, significantly affected as it is by its external regulatory environment and its competitive setting.

It is generally recognised that the primary objective of competition is to increase business efficiency via market mechanisms, consequently leading to greater customer welfare. By contrast, regulation endeavours to directly enhance customer protection in a prescriptive manner. Although their comparative merits along several dimensions have been widely examined, their influence on corporate governance choices has received little consideration. This glaring omission is surprising as this aspect is especially relevant to emerging countries such as India and China for several reasons. First, a firm's governance structure typically reflects a number of factors that are likely to be influenced by a country's competition and regulation policies—availability of human capital, existence of conflicts of interest, strength of institutions, and awareness of ethical considerations.[1] Second, previous research indicates that a country's characteristics are much more important than a firm's characteristics when it comes to explaining governance choices.[2] Third, since emerging economies such as India and China are undergoing rapid changes in their regulatory landscape and competitive environment, a study that directly examines the direct and interactive effects of regulation and competition is deemed to be extremely appropriate at this juncture. As these big emerging countries experience explosive growth, they also hastily try to improve their institutional

framework in addition to enhancing their competitiveness. In fact, the relative impacts of regulation and competition, and their interactive effects on corporate governance are of relevance to all countries that are facing rapid changes in their competitive environment.

The rest of this paper is organized as follows. The next section provides the theoretical background that is relevant for examining the relative effects of regulation and competition on the quality of a firm's corporate governance. In section 3, the hypotheses that form the basis of the empirical tests are developed. Section 4 contains a description of the data and the sample selection process. The empirical results are reported in section 5, and the concluding comments are provided in the final section.

2. Theoretical background

We review below the relevant literature pertaining to the four popular theoretical frameworks of corporate governance—agency, resource-dependence, stakeholder, and institutional. This is followed by a description of the current state of research on measuring the level and variation in the quality of corporate governance. Finally, the relevant theoretical framework for characterising the key variables of regulation and competition is delineated.

Frameworks of corporate governance

Our interest is in how different theories of corporate governance inform the means underlying the impact of regulation and competition on corporate governance. While agency and resource-dependence theories are associated with the competitive elements of corporate governance, institutional and stakeholder theories collectively imply that compliance with norms and mandates also drive firm-level corporate governance.

Agency theory

The classical arguments of Jensen and Meckling (1976) propose that ownership and managerial interest may not be aligned, leading to agency costs (Jensen, 1986; Jensen & Meckling, 1976). Past research posits that

the resolution of agency costs would increase a firm's performance (Daily et al., "Governance through ownership", 2003; Tsipouri & Xanthakis, 2004). Gillette et al. (2003) show that when agency costs are especially severe, having outside directors in control can prevent inefficient outcomes. Agency theory therefore also leads to the view that firms with high levels of agency are liable to face threats from other firms in the environment, through the mechanism of the market for corporate control (Jensen & Ruback, 1983). This assumes the functioning of an efficient competitive environment in which information asymmetries are negligible and competitive pressures are high. Efficient competition is also a prerequisite to the general belief that reduced agency and increased managerial efficiency would facilitate performance benefits in the form of improved market valuation. We therefore suggest that the agency theory of corporate governance is expected to explain the effects on a firm's corporate governance especially in competitive environments.

Resource-dependence theory

Boards of directors can contribute to the firm in a variety of ways such as by giving advice and the benefit of their expertise, and contributing social capital—legitimacy and links to other organisations—cumulatively described as board capital (Hillman & Dalziel, 2003). The association between board capital and a firm's performance is well documented (Dalton et al., 1999; Pfeffer, 1972), thereby making the resource-dependence view a key theory in corporate governance. Dalton et al. (1999) posit that larger boards potentially bring more value. However this view essentially presumes that firms are in a position to benefit from their board capital, implying that the organisation is an efficient one. The general proposition that such human capital is of value also presumes the existence of a reasonably efficient labour market. Similarly relational capital, such as channels of communication, is likely to be of more value in situations where such channels offer firms a competitive edge or an increased advantage over their competitors. The resource-dependence theory therefore is also best applied in competitive environments.

Stakeholder theory

The concept of stakeholder management was proposed by Freeman (1984) to address the ethical and moral considerations of business in addition to the more competitive ones. These views have recently gained more popularity and have spilled into the investing community. Socially Responsible Investing is the term coined to represent investments that take ethical considerations into account in addition to profit potential. The stakeholder theory provides a role for intangible capital and is associated with better stock price performance (Kemp & Osthoff, 2007). In general, the functioning of an effective system of stakeholder management is consistent with a compliance regime utilising social norms. As such, the stakeholder theory provides links to the regulatory aspect of corporate governance.

Institutional theory

The rich literature related to this theory shows that countries with institutions that protect investors better enjoy higher stock market valuations, lower cost of capital, and better access to external finance (Beck et al., 2003; Durnev & Kim, 2005; Gupta et al. 2010; Klapper & Love, 2004; Rajan & Zingales, 1998). Doidge et al. (2007) show that in countries with weak development, it is costly to improve firm-level corporate governance because the institutional infrastructure is lacking, and good governance has political costs. Gupta et al. (2010) find evidence of complementarity between country-level investor protection and firm-level corporate governance. The institutional perspective assumes that the business is adequately regulated and authorises institutions to recognise and reward firms with good governance while denying resources to badly governed ones. As such, the institutional theory links strongly to the regulatory facet of corporate governance.

The basic view of this paper is that regulation and competition directly and interactively influence firm-level corporate governance. We examine two aspects of corporate governance to conduct empirical tests—the level of corporate governance quality and the variation in corporate governance.

Our primary interest is in the level of corporate governance quality, and this stems from the plethora of evidence that suggests that better corporate governance leads to better performance (Brown and Caylor, 2006; Durnev & Kim, 2005; Peng, 2004). Academicians have made several attempts to measure the quality of corporate governance. Among these the governance index of Gompers et al. (2003), the entrenchment index of Bebchuk and Cohen (2005), and the anti-takeover index (ATI) of Cremers and Nair (2005) deserve special mention. They measure the quality of governance based on the anti-takeover measures embedded in their corporate charter. Currently there are several sources for corporate governance ratings. Principal among them are the governance ratings provided by Standard and Poor's, FTSE (ISS), Credit Lyonnais Securities Asia (CLSA), and Riskmetrics. The ISS governance scores cover developed countries. The CLSA ratings cover less-developed countries and recently emerged countries. We use the CLSA ratings to measure firm-level corporate governance.

Our second dependent variable is the variation in a firm's corporate governance from the environmental average. This measure is a proxy for within-country convergence. There are two streams of research regarding the convergence of corporate governance practices. One stream (Aguilera & Jackson, 2003) predicts that global forces will result in a convergence towards the Anglo-American model. The other stream (Bebchuk & Roe, 1999) emphasises historical path dependence advancing variation in corporate governance practices. In this paper, we look at the effects of regulation and competition on convergence in corporate governance practices. We examine within-country convergence and extract implications for the issue of cross-country convergence.

Regulation and competition

We define regulation as positive legislation and mandate, designed to enhance investor and shareholder protection, as opposed to the possible interpretation of regulation as an impediment or obstacle to the efficient conduct of business. This is in keeping with previous operationalisations of regulation in terms of shareholder protection (La Porta et al., 1998), judicial efficiency, and support for business (Klapper & Love, 2004),

and also positions our paper in line with prior findings that positively associate the level of regulation in an environment with the quality of corporate governance therein. Similarly we define competition as the operation of market mechanisms which allow for the conduct of business whereby stronger competition leads to more efficient markets. Therefore conditions with strong regulation and competition in general are viewed as desirable.

Our choice of regulation and competition as the predictor variables of interest is motivated partly by emerging research and partly by practice. Social factors such as regulation as well as economic factors such as a competitive environment distinctly and interactively influence corporate governance (Aguilera & Jackson, 2003). Each of these forces shares links with the other (Aoki, 1990), and the influence of each one may even be contingent on the other (Aguilera & Jackson, 2003). Further, governance practices found in the real world tend to emerge from a confluence of the actions of managers and policy-makers. Policy-makers attempt to change the governance environment through regulation, and while managers would be concerned with regulation, they would also be strongly driven by the competitive environment in their decision-making.

3. Hypotheses

We utilise the four corporate governance perspectives of the institutional, stakeholder, agency, and resource-dependence theories to develop hypotheses that relate regulation and competition to the level and the variation in corporate governance quality.

Based on the work of La Porta et al (1998, 1999), we argue that regulation should have a positive impact on the level of corporate governance quality. When regulation is strong, firms would comply with corporate governance stipulations in order to avoid potential punitive repercussions. Further, since regulations empower stakeholders, firms would try to manage them and their interests by increasing the level of corporate governance quality.

Based on the agency and resource-development theories, we posit that as competition intensifies firms may utilise corporate governance quality to gain competitive benefits such as reduced cost of capital or improved access to resources (Khanna & Palepu, 2004a, 2004b; Hail & Leuz, 2006; Chen et al., 2009; Gupta et al., 2010). We suggest that competitive forces in themselves serve to enhance corporate governance, distinct from the positive effects of regulation.

In situations where regulation is strong, firms would have already benefitted from reduced agency costs and increased access to resources. Under these conditions, firms would not find it efficient to allocate further resources to enhance corporate governance quality. They may instead direct additional resources to deal with competition. Thus we suggest that the dual benefits arising from regulation and competition may not be distinct, but the one may subsume the other when both regulation and competition are strong. Firms may even consider devoting fewer resources to enhancing corporate governance quality under conditions of intense competition. We therefore posit that the interactive effect of competition and regulation could have a negative impact on firm-level corporate governance quality.

The coercive nature of a clearly defined regulatory environment would result in isomorphism (Scott, 2001) with respect to corporate governance quality. Since the firms within a specific country environment are exposed to the same regulatory regime, we would logically expect such firms to have similar corporate governance quality. As the regulatory mandate becomes stronger, the coercive nature of this force would ensure higher compliance with prescribed standards, and would consequently reduce the variation in firm-level corporate governance quality. We therefore hypothesise that regulation has a negative effect on the variation in firm-level corporate governance quality.

In an environment of intense competition, the relative level of corporate governance quality is a crucial factor. Firms may signal their superiority through corporate governance quality to enjoy differential access to resources. Thus corporate governance could be utilised by firms to get an additional source of competitive advantage for themselves.

Overall, we expect superior firms to benefit from increased legitimacy, beneficial comparison, enhanced reputation, and therefore higher market valuation and differential access to resources. Since investment in corporate governance quality is not costless, other firms of lower standing would be unable to mimic the behaviour of superior firms. Thus we expect competition to have a positive effect on the variation in firm-level corporate governance quality.

4. Data and sample selection

The sample was selected on the basis of the availability of firm-level corporate governance scores. The data on firm-level governance was obtained from Credit Lyonnais Securities Asia (CLSA, 2002). The corporate governance scores are contained in the CLSA Emerging Markets report entitled Make Me Holy…But Not Yet! (CLSA, 2002), which represents the most comprehensive report quantifying the quality of governance at the firm level, and covers 495 firms from 25 emerging countries. The report categorises corporate governance into seven components—Discipline, Transparency, Independence, Accountability, Responsibility, Fairness, and Social Awareness. The aggregate score was arrived at by using weights of 15% for the first six components, and 10% for the Social Awareness component. The components and the questionnaire used for quantifying the scores are provided in the Appendix at the end of the paper. Table 1 shows the distribution of the firms over the various countries. Due to the low number of observations in three Latin American countries—Brazil, Chile, and Mexico—the firms from these countries were clubbed together, and were treated as representing the South American region collectively.[3]

Table 1: Country-wise distribution of data

Environment	Country	Number of Firms in Sample
Weak regulation, weak competition	Indonesia	18
	Philippines	20
	Turkey	17
Weak regulation, strong competition	India	79
	Korea	24
Strong regulation, weak competition	Latin America	45
	South Africa	40
Strong regulation, strong competition	China	25
	Hong Kong	38
	Malaysia	47
	Singapore	43
	Taiwan	47
	Thailand	20
	Total	**463**

These data have been well used in recent studies (Black et al., 2006; Chen et al., 2009; Doidge et al., 2007; Durnev & Kim, 2005; Klapper & Love, 2004; Krishnamurti et al., 2005). Palepu et al. (2002) in particular use the CLSA (2002) report in their study of convergence in corporate governance at the country level, and after testing, they note that the CLSA data does indeed meet the standards of reliability required. We preferred the CLSA (2002) report as our source of data on corporate governance over other available academic and practitioner indices for two reasons: a) the construction of the index with emphasis on the most number of indicators or mechanisms of governance; and b) the availability of data for as many countries as possible.

Our source of the data on the independent variables used in this study was the World Competitiveness Report (WCR, 2000), which has also been used recently by other researchers (Glaeser et al., 2001; Yiu & Makino, 2002; Wan & Hoskisson, 2003). We lagged the independent variables by a year in order to allow time for firms to respond to environmental forces. The WCR (2000) ranks countries according to four components—Government Efficiency, Economic Performance, Business Efficiency and Infrastructure—covering a total of 286 criteria. Using a standard deviation

method (SDM) that is discussed in detail in each edition of the World Competitiveness Yearbook, the criteria are scaled to compute the overall competitiveness factor and its components for each country surveyed (WCR, 2000). We used Government Efficiency (which covers 73 criteria) as proxy for the strength of coercive forces in a country, and Economic Performance (which covers 79 criteria) as proxy for the strength of mimetic forces, as these two components were best suited to capture the conditions based on mimetic and coercive influences as we conceptualised them.

The Government Efficiency component emphasises the existence, strength, and efficiency of various governmental entities, their functions and regulatory activities which capture both the presence and the strength of regulatory forces, which are particularly relevant to business. Included in this component are sub-components dealing with the nature and quality of various business legislations, the role of the central bank, and the extent of protectionism among others. We prefer this measure of overall efficacy of the regulatory environment over measures of legislation alone, to capture both the existence of mandates and their adequate and efficient enforcement. In keeping with our definition of regulation as a positive impetus to business, the Government Efficiency component accords a lower ranking to countries that have protectionist regulation which either impairs economic development (such as subsidies) or is inflexible. Political interference in judicial processes and bureaucratic inefficiency are also considered to be negative. The component also includes variables that examine the role of the judiciary, existing legislation and potential to introduce legislation, transparency, and corruption, suggesting that the Government Efficiency component of the WCR (2000) is a valid measure of regulation in the context of the present study.

Similarly, the Economic Performance component covers basic economic and competitive elements such as foreign and domestic trade, foreign investment, threats to factors of production, economic health of the economy, and potential for growth, all of which capture the overall competitive health of the country economy, and would therefore reflect the likelihood that firms would use their corporate governance mechanisms in

order to meet competitive pressures. For example, the potential to access capital markets and foreign investments, as captured by the WCR (2000), could impact firm-level corporate governance (Fiss & Zajac, 2004), and may provide incentives for firms to engage in mimetic behaviour vis-à-vis corporate governance. This component includes variables traditionally considered as indicators of the level of competition in countries such as Gross Domestic Product (GDP) and Purchasing Power Parity (PPP), as well as recent factors that are linked to competition and market efficiency such as economic resilience, real growth rates of goods and services, exports and employment, as well as Foreign Direct Investment (FDI), and outflow of investment.

We therefore identify the WCR (2000) in general, and the Government Efficiency and Economic Performance components in particular to be appropriate measures of coercive and mimetic influences for the purposes of this study.[4] We specifically tested these two components of the WCR (2000) against other available measures to establish their reliability. We found that our measure of regulation—the Government Efficiency component—was strongly correlated with another measure of regulation that was used in prior corporate governance research—the country measure of Legality used by Klapper and Love (2004) in their study of corporate governance (0.9, $p < 0.01$). We also found that the Economic Performance component was strongly correlated with the Global Competitiveness Rankings (GCR, 2000) reported by the World Economic Forum (0.59, $p < 0.01$), suggesting that the former is an accurate and reliable measure of competition.

We coded the regulation and competition scores for each country into categorical variables ('1' for strong, and '0' for weak) based on whether they fell below or above the middle rank for the population subgroup covered by the WCR (2000) (greater than or less than 20 million).[5] We calculated the four combinations of these two components of the environment, namely weak/strong regulation and weak/strong competition. The distribution of the countries across the four conditions is also represented in Table 1. We found that Indonesia, the Philippines, and Turkey fared poorly on both the

regulation and competition components. India and Korea exhibited strong competition, but were poor on regulation. South Africa and Latin America were strong on regulation, but weak on competition. Six of the fifteen countries in our sample exhibit strong regulation and strong competition. While we expected economies such as Singapore, Hong Kong, and Taiwan to belong to this category, we found it particularly interesting to see that China, Malaysia, and Thailand were also included in this group.

The corporate governance scores of firms and the variance of corporate governance scores are the dependent variables for the tests of our hypotheses. We measured firms' corporate governance using the weighted average of the seven components of the CLSA corporate governance scores. The variation in corporate governance scores of firms is sensitive to both the number of firms in the country, as well as the difference in the corporate governance scores of the firms. The sum of the values of this variable for all the firms in a particular country would give the variance of the corporate governance scores for all the firms in that country in our dataset. Variance in CG is defined as follows:

$$\frac{(\text{Country Average CG} - \text{score Firm CG Score})^2}{N_{\text{country}} - 1}$$

Control variables

Since our hypotheses broadly examined the social and economic contexts of corporate governance, there remained little by way of environmental factors that did not come under the purview of these two variables. We were aware that the inclusion of further variables in our model could result in over-specification; on the other hand this could contribute positively to the statistical outcomes of our tests. In order to avoid such potential over-specification, and also bearing in mind that the focus of our testing was predictive as opposed to explanatory, we consciously traded off the explanatory potential of our model as a whole for accurate predictive capability.

However, given that our process of calculating the two independent variables—regulation and competition—involved rankings which were

bifurcated on the basis of country size, we included a control variable to capture the potential effects of the same. We controlled for country size using a simple categorical variable which had a value of '0' if the population of the country was less than 20 million, and a value of '1' if the population was 20 million or greater (following the WCR (2000) classification of country size). We specifically did not control for industry- and firm-level effects in the interests of parsimony. Recent literature suggests that the specific industry does not seem to affect corporate governance, with the exception of the distinction between financial services and non-financial services (Doidge et al., 2007; Palepu et al., 2002).

5. Summary of empirical results

We used a lag of a year between the independent and dependent variables. This was done to ensure that the firms had the time and opportunity to react to environmental changes through their corporate governance practices. We performed OLS regressions to test the validity of the hypotheses developed in section 3. We used a partial Gram-Schmidt transformation procedure to orthogonalise the interaction variable (regulation x competition). This was done to ensure its mathematical independence from other predictor variables. For robustness checks, we used the GLM-Multivariate analysis to simultaneously estimate the effects of the independent variables on both the dependent variables. Our results were qualitatively similar. The results of our hypotheses tests are summarised below.[6]

Differences across countries

In countries where regulation is strong, one would expect firms to comply with the best practices of corporate governance so as to minimise the chances of punitive action from the regulator. That is, regulation should have a positive impact on the quality of corporate governance. Similarly, when competition is strong, high-quality governance choices can attract favourable attention and enhance company legitimacy in the eyes of the investors. Consequently, firms may use corporate governance as a means of gaining a competitive benefit such as a lower cost of capital, or better

access to resources, i.e., competition should also have a positive impact on the quality of corporate governance.

These hypotheses are only partly supported by the data. Although stronger regulation does indeed have a positive effect on firm-level governance scores, our empirical results do not support the predicted positive impact of competition on firm-level corporate governance scores. Thus the results of our study imply that a competitive business environment does translate into a higher corporate governance score for the typical firm. Furthermore, empirical evidence supports a negative interactive effect of regulation and competition on firm-level corporate governance scores. Our results imply that for a typical firm in a country with strong regulation, a more competitive environment results in a lower corporate governance score.

Differences within countries

Also of interest is the variation in the quality of governance choices within a given country. It is expected that where regulation is strong, its coercive nature should ensure higher compliance with prescribed behaviour (including governance choices), and consequently reduce diversity in corporate governance within a given country. On the other hand, a competitive business environment is characterised by an efficient and rapid transmission of information; it is an environment in which firms have incentives not only to exhibit good governance but also to display governance that is better than that of their competition. The relative quality of governance is important and a typical firm in this environment would seek to derive significantly more benefits from corporate governance than its competitors. This tendency to search for an edge over competitors should lead to greater diversity in governance choices.

Our results indicate that this is exactly what happens—all else being equal, the variation in corporate governance scores is significantly greater in strong-competition countries, but significantly less in strong-regulation countries. There appear to be two distinct forces at work which act in opposite directions. One of them arises from regulatory strictures

and engenders convergence, i.e., the tendency of firms to compete in achieving the highest corporate governance scores. The other force occurs due to competitive pressures and produces a divergence in corporate governance scores. The results of our empirical work suggest that some firms operating in a competitive environment need to display superior corporate governance quality as compared to their peers in order to gain access to resources, and enhance their credibility. This tendency to increase relative corporate governance scores is the underlying driving force for the observed divergence.

6. Conclusion

We draw upon multiple theories of corporate governance to examine the effects of competition and regulation on firm-level corporate governance quality. We find that regulation enhances firm-level corporate governance and within-country convergence. Competition has a negative effect on corporate governance. The interactive effect of regulation and competition is negative on firm-level corporate governance. Furthermore, competition reduces within-country convergence.

Internal, i.e., firm-level governance choices are significantly influenced by external (country-level) choices. This suggests that governance choices are likely to converge across countries while simultaneously diverging within countries. For example, while firms in the top governance score cluster of each country will be different from lower-scoring clusters of firms in the same country, the similarity of the competition-regulation environment in which they operate means that these firms are likely to be very similar to firms in the top governance clusters of other countries.

Our paper makes two significant contributions. First, it provides an integrative view of corporate governance that incorporates factors contributing to the variation in corporate governance across countries. Second, we contribute to the debate on within- and cross-country convergence of corporate governance. While some researchers pontificate on the eventual convergence of global corporate governance practices, others have their own doubts. The latter viewpoint is reinforced by

studies on temporal convergence in corporate governance which reveal significant cross-country variation due to path-dependence in the evolution of corporate governance practices. We provide an economic argument, namely that competition detracts from within-country convergence in corporate governance.

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Notes

[1] These factors are the respective subjects of four popular theoretical frameworks of governance—resource dependency, agency, institutional, and stakeholder.

[2] See Doidge et al. (2007) for a detailed discussion.

[3] The values of the independent variables—regulation and competition—were found to be similar for these three countries, as were the values of the dependent variables. We therefore contend that aggregating data from these three countries into a single region is appropriate.

[4] The Infrastructure and Business Efficiency components were examined for the relevance of their constituent elements, and were found to be less relevant to the issue under examination in this paper, as compared to the two components that we used.

[5] The bifurcation of rankings according to country size for the year 2000 was made available retrospectively by IMD in 2003, and was advised as a more accurate representation of the relative position of countries as per the WCR (2000).

[6] For further details of the test results, see Udayasankar et al. (2005).

Appendix

The 57 questions addressed to analysts in the evaluation of firms' corporate governance by the CSLA are listed below.

Discipline (15%)	
1	Has the company issued a mission statement that explicitly places priority on good corporate governance, or has the company or management publicly articulated principles of good corporate governance that it is committed to maintaining?
2	Is the senior management incentivised to work towards a higher share price for the company? E.g. is more than 50% of net worth of CEO or controlling family in the company's equity, or is at least 50% of expected remuneration for the top executive(s) tied to the value of the shares?
3	Does the management stick to clearly defined core businesses?
4	a) What is the management's estimate of its cost of equity? b) Is the management's view of its cost within 10% of a CAPM derived estimate?
5	a) What is the management's estimate of its weighted average cost of capital? b) Is the management's estimate of its cost of capital within 10% of our estimate based on its capital structure?
6	Over the past five years, is it true that the company has not issued equity, or warrants for new equity, for acquisitions and/or financing new projects where there was any controversy over whether the acquisition/project was financially sound, or whether the issue of equity was the best way of financing the project? Is it true that there is no reason to be concerned on these grounds about the issue of equity/warrants for new equity in the foreseeable future?
7	Does the senior management use debt for investment/capex only where ROA (or average ROI) is clearly higher than cost of debt and where interest cover is no less than 2.5? In using debt, has the management always shown sensitivity to potential asset-liability duration and currency mismatches?
8	Over the past five years, is it true that the company has not built up cash levels through retained earnings or cash calls that have brought down ROE?
9	Does the company's annual report include a section devoted to the company's performance in implementing corporate governance principles?
Transparency (15%)	
10	Has the management disclosed three- or five-year ROA or ROE targets?
11	Does the company publish its annual report within four months of the end of the financial year?
12	Does the company publish/announce semi-annual reports within two months of the end of the half-year?
13	Does the company publish/announce quarterly reports within two months of the end of the quarter?

14	a) In the past twelve months, what is the longest time period between the board meeting to accept results for a period (quarterly/half-yearly/finals), and the announcement of the results? b) Has the public announcement of results taken no longer than two working days after the board meeting? Is it true that there has not been any case in the past five years when the share price moved noticeably just before the release of results, and in a direction that anticipated the results?
15	Are the reports clear and informative?
16	Are the accounts presented according to IGAAP? Are the accounts free of substantial non-IGAAP compliant qualification?
17	Does the company consistently disclose major and market sensitive information punctually? Is it true that the company has not in the past five years ever failed to disclose information that investors deemed relevant in a timely fashion?
18	Do analysts have good access to senior management? Good access here implies accessibility soon after results are announced, and timely meetings where analysts are given all relevant information and are not missed.
19	Does the company have an English language Website where results and other announcements are updated promptly (no later than one business day)?
Independence (15%)	
20	Is it true that there has been no controversy or questions raised over whether the board and senior management have made decisions in the past five years that benefit themselves at the expense of shareholders?
21	Is the chairman an independent, non-executive director?
22	Does the company have an executive or management committee that makes most of the executive decisions, which is substantially different from members of the board and not believed to be dominated by major shareholders?
23	Does the company have an audit committee? Is it chaired by a perceived genuine independent director?
24	Does the company have a remuneration committee? Is it chaired by a perceived genuine independent director?
25	Does the company have a nominating committee? Is it chaired by a perceived genuine independent director?
26	Are the external auditors of the company seen to be completely unrelated to the company in other respects?
27	Does the board include no direct representatives of banks and other large creditors of the company?
Accountability (15%)	
28	Are the board members and members of the executive/management committee substantially different such that the board is clearly seen to be playing a primarily supervisory role as opposed to an executive role?

29	Does the company have non-executive directors who are *demonstrably and unquestionably independent?*
30	Do independent, non-executive directors account for more than 50% of the board?
31	Are there any foreign nationals on the board who are seen as providing added credibility to the board's independence?
32	Are full board meetings held at least once a quarter?
33	Are board members well briefed before board meetings? Are they provided, as far as the analyst can tell, with the necessary information for effective scrutiny of the company prior to the meeting, in a clear and informative manner?
34	Does the audit committee nominate and conduct a proper review of the work of the external auditors as far as the analyst can tell?
35	Does the audit committee supervise internal audit and accounting procedures as far as the analyst can tell?
Responsibility (15%)	
36	If the board/senior management have made decisions in recent years seen to benefit themselves at the expense of shareholders, has the company acted effectively against the individuals responsible and corrected such behaviour promptly, i.e., within six months?
37	Does the company have a known record of taking effective measures in the event of mismanagement? Over the past five years, if there were flagrant business failures or misdemeanours, were the persons responsible appropriately and voluntarily punished?
38	Are there any controversies or questions over whether the board and/or senior management take measures to safeguard the interests of all and not just the dominant shareholders?
39	Are there mechanisms to allow punishment of the executive/management committee in the event of mismanagement as far as the analyst can tell for certain?
40	Is it true that there have been no controversies/questions over whether the share trading by board members have been fair, fully transparent, and well intentioned?
41	a) How many members are on the board? b) Is the board small enough to be efficient and effective?
Fairness (15%)	
42	Is it true that there have not been any controversies or questions raised over any decisions by the senior management in the past five years where majority shareholders are believed to have gained at the expense of minority shareholders?
43	Do all equity holders have the right to call General Meetings?
44	Are the voting methods easily accessible?

45	Is all the necessary information made available prior to the General Meeting?
46	Is the senior management unquestionably seen as trying to ensure fair value as reflected in the market price of the stock, by guiding market expectations about fundamentals in the right direction through frank discussions on risk/returns, actions like share buy-backs, investor meetings, etc?
47	Is it true, over the past five years, that there have been no questions or perceived controversy over whether the company has issued depositary receipts that benefited primarily major shareholders, nor has the Company issued new shares to investors near peak prices, nor have the major shareholders sold shares near peak prices without prior guidance to the market on why such shares are seen as fully-valued?
48	Does the majority shareholder group own less than 40% of the company?
49	Do foreign portfolio managers and/or domestic portfolio investors who have a track record in engaging management on CG issues own at least 20% of the total shares with voting rights?
50	Does the head of Investor Relations report to either the CEO or a board member?
51	a) What is the total remuneration of the board as a percentage of net profit after exceptionals? b) Over the past five years, is it true that the total directors' remuneration has not increased faster than net profit after exceptionals as far as the analyst can tell?
	Social (10%)
52	Does the company have explicit public policy statements that emphasise strict ethical behaviour, i.e., one that looks at the spirit and not just the letter of the law?
53	Does the company have a policy/culture that prohibits the employment of the under-aged as far as the analyst can tell?
54	Does the company have an explicit equal employment policy, i.e., no discrimination on the basis of sex, race, religion, etc?
55	Does the company adhere to specified industry guidelines on sourcing of materials as far as the analyst can tell?
56	Is the company explicitly environmentally conscious? Does it promote the use of environmentally efficient products, or take steps to reduce pollution, or participate in environment-related campaigns?
57	Is it true that the company has no investments/operations in Myanmar?

3

Regulation in Corporate Governance and Elsewhere: The Continuing Debate

Chiranjib Sen, N. Balasubramanian

1. Introduction

Ever since the beginning of civilisation and the general acceptance of the concept of an orderly and relatively fair society, the nature and extent of the regulatory role of the government have been in a state of constant flux, ranging from the peremptory and the detailed to the permissive and the persuasive. A plethora of variations (mostly dictated by the nature of the times and the stages of cultural and libertarian development of societies) have been tried with different degrees of success. Given that there is (and can be) no one-size-fits-all prescription in this regard, this paper traces in part this journey over the years and around the world, and is organised as follows. Section 2 sets out some of the general principles that form the basis of regulation in terms of a covenant between the regulator and the regulated; Section 3 traces some of the key trends preceding and following the 2008 financial meltdown that shook (and continues to affect) the interdependent world economies. Section 4 discusses the developments in the arena of corporate governance regulation in recent times, and Section 5 concludes the discussion with some prescriptive suggestions relevant to emerging economies like India.

2. Underlying Principles of Regulatory Acceptance and Empowerment

While a comprehensive discussion of the sovereign authority of the

state to govern through legislation and regulation—directly or through duly empowered regulatory agencies—is beyond the scope of this paper, it would be useful for our purposes to identify the general principles by which the State derives such authority and the people (including legal entities such as incorporated bodies) agree to be subjected to such regulations. Locke (1892) describes the right of one over another, especially the state over its subjects, as an instrument to protect the liberty and freedom of all, such that in the exercise of one's own right to freedom, one does not encroach on and/or impair another's equal right to similar freedom. The state is empowered to undertake this right so long as the community or nation exists. But why should or would an individual with inherent freedom surrender and be subjected to the dominion of the state unless the individual sees some value for himself in doing so? Mill (1859) (and Rousseau, 1762 before him) discusses the inherent advantages an individual enjoys by joining such a society and subjecting himself to certain sacrifices of individual liberty in return for the safety and security that he would gain against external or internal threats to his life and property, which could be better handled as a group rather than as an individual. But having taken that decision (or being forced into accepting such a decision by an attacking and victorious marauder) the power so vested in the ruler seldom reverts to the individuals except in extreme cases of revolt or secession from the community due to the patent abuse of authority.

State regulation and exemplary punishment in the event of non-compliance have been documented in the Indian scriptural tradition. For instance, the *Mahabharata*[1] (Ganguli, 2000) describes how in the beginning there were no rulers and no concept of punishment since everyone understood and followed those ways of life that were fulfilling to them without interfering with others, and how men later strayed away from the path of common mutual good and wellbeing, and how laws then had to be codified and enforced to ensure that the weak were not overpowered by the strong, and so on.

The power to legislate and regulate, even with force if warranted, is thus derived by the State over its subjects and is expected to be used for

the welfare of all. "There remains, however, the problem that a ruthless majority that has no compunction in eliminating minority rights would tend to make the society face a hard choice between honouring majority rule and guaranteeing minority rights" (Sen, 2009, p. 352). This is also the possibility which regrettably is a frequently observed reality that led Gandhi to comment on the inherently violent traits of a democracy based on majority rule.

Analogously, managers and owners of corporations often with a multitude of shareholders without any active role in the day to day operations of their companies are also prone to the excesses that come with their relative positions of *de facto* power attributable to their operational control and dominance in ownership arising from their stock ownership (which is not necessarily always a majority). By incorporating themselves into a legal entity under the provisions of a state charter or statute, they sacrifice their freedom to a certain extent in return for the benefits of perpetual succession and most often limited liability; publicly traded companies undergo a similar curtailment of their unfettered freedom when they choose to get listed on a stock exchange in return for the concomitant benefits of market access to capital, and relatively increased liquidity, and flexibility of exit when desired.

There is thus always a continuing tension between the governing and the governed with regard to the extent and rigour of regulation that their subjects are to suffer; in practice the flexible equilibrium is reached as a trade-off between the needs of society in public interest and the freedom of operation that would attract and retain investment (in a corporate context). Consultation processes and political debates often reflect an effort (on both sides) to obtain an acceptable compromise. Developments in regulatory regimes have to be viewed in this backdrop as well as in the context of the growing globalisation of business that often necessitates a similar set of considerations between different geographies that push for some measure of convergence of corporate governance regimes in countries.

We first review the market regulation scenario, queered as it is by the global financial meltdown in 2008 originating in the United States and

subsequently spilling over to other inter-dependent economies of the world, not so much for the specifics of the breakdown of the financial sector as for the conflicting regulatory philosophies advocated and practised over the years that eventually contributed to the virtual collapse of the world financial order. We then turn to a consideration of the regulatory scenario in the corporate arena, with particular reference to India.

3. Global Financial Meltdown and Market Regulation

The exact beginnings of protracted systemic failures are not easy to pinpoint. Usually it is a specific event that the triggers recognition of the problem long after it may have commenced its incubation. Soros (2008) fixes the outbreak of the crisis to August 2007 (based on a BBC report)[2] when central banks had to intervene to provide liquidity to the banking system. To understand the role of regulation—or more precisely the lack of adequate regulation—it is necessary to recall the developments in this field, a study to which we now turn.

The state-market context

Institutional dimensions of market economies have been undergoing significant changes over the past decade. The global financial crisis has further accentuated the importance of such institutions and their reform. American and European policy makers and regulators are even now engaged in drafting new legislations and rules that are aimed at creating a more robust regulatory framework for the financial industry and for corporate governance, so that the chances of a repetition of the financial meltdown are minimised. These recent trends in regulation may be viewed as the latest chapter in the unfolding transformation of modern capitalism. The market liberalisation movement had swept the world beginning in the late 1980s. Policy reforms that began as a paradigm shift towards *laissez-faire* and away from government intervention in markets now seem to have come full circle with a new trend toward stronger regulatory governance over financial markets. Despite strong resistance from the powerful finance industry and their political allies in the USA, it is most likely that stronger regulation will receive legislative backing through the bills that

are being discussed by the US Congress (at the time of writing).[3] Globally, regulatory reforms are very likely to extend beyond financial markets, because market failures in the fields of environmental sustainability, climate change, allocation of land and mining rights, and inclusive growth are increasingly evident. Indeed, these failures are at the root of intensifying social unrest and violence in many parts of the world, including India. These problems and their economic underpinnings are addressed through appropriate regulation and supporting institutions. Otherwise, it will be difficult to maintain a social and economic environment that would sustain rapid and harmonious growth.

The state-market dynamic during the globalisation phase has been different for the advanced and the developing countries. In the latter, market reform design was influenced strongly by the "Washington Consensus" policy template.[4] Most of the newly industrialising countries (including the highly successful Asian Tigers) had earlier followed variants of state-led developmental models during the four decades between the Bretton Woods Conference and the oil crises of the 1970s. Backed by the major multilateral institutions, and spurred on by the conservative and influential financial media, the Washington Consensus fundamentally reshaped the economic policies of developing countries, particularly those which experienced economic crises and needed some form of assistance in adjustment. In fact, each national macro-economic and/or balance of payments crisis was an opportunity for the World Bank and the IMF to package their policy reform template along with structural adjustment loans (Stiglitz, 2002). India's reform policies closely conformed to the Washington Consensus when they were launched in 1991. The reforms swept away most of the controls, planning, and closed economy policies that had dominated its economy since the 1950s.

The Washington Consensus policies, in their original form, did not give much emphasis to institutions. Instead the focus was on rolling back the government in both macro- and micro-economic arenas. Within a decade however, it became apparent that these policies were failing in many countries on several counts. For example, income inequality

worsened along most dimensions (personal, regional, and urban-rural). Macro-economic instability continued with a string of financial crises that emerged in Latin America (Mexico, Brazil, Argentina), several former socialist "transition economies" (Russia), and the devastating East Asian crisis of 1997 (with contagion effects that started in Thailand, and spread to Indonesia, Malaysia and South Korea). Even Wall Street was not spared from crisis, as the failure of the leading hedge fund LTCM shook the confidence of the most powerful financial market in the world, and a meltdown was narrowly averted through a rescue package financed by a group of private banks. These recurrent episodes show that unfettered markets and increased competition by themselves are not sufficient to maintain stable growth. The lack of appropriate institutional frameworks also became evident in relation to privatisation. The process was marred by political controversy regarding the design of the bidding mechanism, and charges of corruption and "crony capitalism". Thus it became obvious to most observers that markets needed to be controlled through appropriate regulatory institutions, rules, laws, and policies.

This experience led to the reconsideration of the importance of the institutional framework that is required for markets to function effectively. Recognising this, the market fundamentalist thrust of Washington Consensus policies was augmented to include a number of new institutional dimensions in market reform policies. Thus policy attention began to be given to reforms in corporate governance, anti-corruption measures, prudence in liberalisation of the capital account in international transactions, rules-based trade liberalisation via the WTO, and creation of social safety nets. These new policy goals clearly targeted those areas where systemic failures were evident. By addressing them, the intention was to "get the institutions right" so that markets could work better. While the new approach was an improvement compared to the original Washington Consensus in that it acknowledged the key role of institutions, it still did not accord a high priority to regulation per se. The approach implicitly was for creating better rules and norms for market conduct, supplemented by a limited number of cautious discretionary policies.

In the developed countries, the pattern was different. Regulatory institutions in the US were well established (dating back to the Depression era when President Franklin D. Roosevelt established them to control unstable markets) (McCraw, 1984). Over time however, regulation came to be viewed as dysfunctional. Critics decried the "capture" of regulatory institutions by powerful business interests, and argued that regulation throttled competition, and bred inefficiency. The period of globalisation was therefore marked by a wave of deregulation initiated by Reagan and Thatcher. In many industries (such as air transportation and public utilities), deregulation succeeded in bringing about greater competition and efficiency (Kahn, 1995). This trend received support from the radical ideology of market fundamentalism, which held that competitive markets knew best, and hence *laissez-faire* was the best policy. These classical economic ideas, championed by Milton Friedman and Friedrich Hayek[5] in the modern era, had been edged out by Keynesian economics. But they gained ascendency when the advanced economies floundered in stagflation. The *laissez-faire* ideology was embraced by a resurgent financial sector which replaced manufacturing as the dominant industry. In particular, it found policy support from Alan Greenspan, the long time Chairman of the US Federal Reserve Board. This combination of a rising financial industry and the Greenspan-led Fed set the stage for a long phase of non-interventionist, easy monetary policy, and far-reaching deregulation of the financial sector. Greenspan was reluctant to tighten money supply in response to asset price inflation. He was also unwilling to take other restraining steps (such as higher margin requirements) to curb financial investors even when asset market prices rose sharply, and many people began to wonder if a speculative bubble might be forming (Stiglitz, 2003, p. 56).

The failure of macro-economic policy to act early is one element which can allow an asset bubble to develop. Another element is rapid deregulation. Much of the turbulence in American markets in recent decades is associated with deregulation. For example, the deregulation of telecommunications is linked to the technology bubble that burst in 2001; the deregulation of electricity markets led to the crisis in California; the deregulation of

banking (repeal of the Glass-Steagall Act) created conflicts of interest in banks; and the weak regulation of the accounting sector underlay the subsequent accounting scandals and failures of leading accounting firms (Stiglitz, 2003). Despite these problems, the overall policy direction in the USA remained oriented towards deregulation throughout the 1990s and well into the first decade of the new millennium, as far as regulation by the government was concerned. The story was broadly similar in the UK and in other OECD countries. The main thrust of regulatory reform was to reduce the regulatory burden and administrative burden on private firms (Frick & Ernst, 2008).

The trend favouring deregulation was halted abruptly by the onset of the global financial crisis that shook the world beginning in 2008. There was little doubt that the crisis was the result of the comprehensive failure of financial markets that began in Wall Street, the very heart of global financial system. The crisis spread quickly to most major markets because of the pre-eminent position of the US economy, and the connectedness of global markets. It was triggered by the collapse of the US housing mortgage market. The real estate bubble had formed over a long time. It was aided by two factors—aggressive lending practices at the primary level that targeted sub-prime borrowers, and financial innovations in the creation of complex asset-backed securities that were essentially bundles of underlying mortgages. The asset-backed securities were then rated by leading rating agencies, and sold. These factors allowed the mortgage market to expand very rapidly. The originators of the mortgages could thereby shift the risk to other investors. The collapse of the market occurred when some of the sub-prime borrowers began to default on their mortgages, which in turn created a chain reaction of panic. Holders of the asset-backed securities found that they could not estimate the risk they were actually carrying, and prices plummeted when they tried to sell. The crisis revealed beyond doubt the disastrous consequences of the lack of an appropriate regulatory framework.

Apart from the structural and institutional factors associated with the crisis, there was also the related issue of corporate behaviour. Did the

financial firms behave responsibly towards their clients and customers? Did they behave ethically in creating a situation in which they could spread risk to others without fully disclosing the risk to their customers? Were they truthful in disclosing information about their own financial condition? These issues are the topics of most public discussions currently. Thus the stage has been set for a new round of regulation as well as associated legal and policy initiatives. These will impact both the functioning of regulatory institutions and the governance of corporations.

Lessons are still being learned from the experience of the financial meltdown. Several sources of financial market failure that contributed to the crisis have been identified, including the ability of banks which originate the loans to pass on the entire risk through securitisation and sale (the originate-and-distribute model). This system created a strong incentive to create more risky loans. Moreover banks which funded the home loans did not have direct contact with the borrowers. Instead they outsourced the activity to independent mortgage brokers who received fees. These brokers had little incentive to be careful in collecting information about the borrowers. The use of structured investment vehicles created off-balance sheet entities that enabled banks to act non-transparently and to show a lower risk to regulators, and thereby to carry inadequate amounts of capital. These features illustrate how a system based on misaligned incentives had developed. Regulatory action is needed to address the propensity of firms to pursue immediate profits at the cost of creating high risk to the financial system as a whole. The scope and speed of changes that will be introduced will depend, however, on the outcome of the political battles that are already being fought in the major countries. The influence of conservative *laissez-faire* ideology on the US public is still considerable, and the lobbying power of financial business interests will no doubt be utilised to block significant legislation.

Regulatory ideas and institutions

From the viewpoint of society, regulation is needed to improve market outcomes when markets fail. Market failures can originate from several sources (Stiglitz, 2010). The conventional understanding is that markets

fail in the case of public goods, and when there are externalities.[6] There is however, another source of market failure—imperfect information—which has assumed great importance recently. Addressing information failure is at the core of ongoing regulatory initiatives. This is due to its relevance in the context of financial market failures, when information regarding the quality of the product or the riskiness of a financial asset is asymmetrically distributed between the market participants. Market outcomes in such cases will be biased against the party with deficient information.

Regulation of financial markets may also be needed to protect against "irrational behaviour" by market participants. One of the lessons that can be learned from recent financial crises is that irrational behaviour plays a key role in creating and exacerbating asset market boom and bust cycles. Financial markets are prone to volatility because of sharp swings of optimism and pessimism in expectations. Intervention is justified in such cases because the irrational behaviour of a few market participants can destabilise the entire economic system, and thereby hurt others. Precautionary or defensive regulations are therefore necessary to curb such volatility. These ideas go against the grain of conventional economic theory, but they have influential adherents whose views are gaining ground. Standard economic theory is founded on the axiom of the rationality of market participants. However, market practitioners like Soros (2008) and academic experts like Akerlof and Shiller (2009) have challenged the relevance of these rationality assumptions on behavioural grounds.

Soros has long argued that financial markets are inherently prone to boom-bust sequences because the market participants (as well as regulators) act based on imperfect knowledge and under uncertainty. Market *fundamentals* do not have an existence *independent of the expectations of the market participants.* The expectations of market participants play a crucial role in their demand and supply decisions. However, *their actions themselves influence the events on which their expectations are based.* The market participants' cognition of reality is inextricably intertwined with their market buy-and-sell actions. Hence, there is a circularity in the process—what Soros terms "reflexivity" (2010, pp. 12–15). Rational

economic decision-making in the traditional sense is simply not possible under these circumstances. Financial asset prices therefore do not move towards any equilibrium, but continually oscillate. Sometimes a trend develops, and this influences expectations in a self-fulfilling manner. This process, when based on leveraging, can lay the foundation for a boom-bust sequence. Sometimes the boom can be sustained, and this could be followed by a serious bust, when exaggerated expectations can no longer be sustained. Akerlof and Shiller (2009) make a similar argument, noting the wide divergence between actual stock prices and fundamentals. According to them, investment decisions are made under conditions of "fundamental uncertainty" and "straight from the gut", rather than rational calculation. They focus on feedbacks that underlie speculative bubbles—such as "price-to-price feedback" (emphasised by Soros), and also the feedback from asset prices to the real economy. Thus, precautionary regulation is needed to curb irrational exuberance or pessimism.

Finally, regulation is needed to ensure that inequalities of distribution that may be inherent in market outcomes are moderated, and brought in line with society's political preferences. These issues are more urgent in the context of developing countries. For example, efforts are needed to ensure that private sector providers of telecommunication services reach out to the rural areas, and that the poor have access to credit.

Regulatory strategies can help mitigate market failures. Their appropriate design is an important challenge for policy. The goal is to find the right balance between the benefits of market efficiency and dynamism on the one hand, and the costs of market failure on the other. Regulation, in order to remain relevant and effective, must also be able to cope with the fact that technological and business environments can change rapidly. These changes can strain the regulatory capacity of government regulators. To mitigate this problem, there has been a significant trend towards different varieties of self-regulation as well as towards certification by external expert bodies such rating agencies (Baldwin & Cave, 1999).

There are three basic instruments that are normally used in regulation (Stiglitz, 2010). These are Information Requirements, Proscriptions

(specifications of what firms may not do), and Mandates (actions that firms must take). In the case of conventional market failures involving externalities and public goods, regulation typically involves tax and/or subsidy to correct the incentive embedded in the price. In some cases, there may be physical or quantitative restrictions on what the firms may do. In the case of information failure, regulation requires firms to truthfully disclose relevant information. The issues concerning disclosure are complex. In principle, information relating to conflicts of interest, ownership, and remuneration should be disclosed, as these enable customers or investors to exercise better judgment. Sometimes firms deliberately seek to evade disclosure requirements by giving information in a form that deceives or confuses the user of the information. Hence the form of disclosure needs to be regulated as well.

Moreover it is often necessary to go beyond disclosure. Market participants may not be able to process the information provided by firms, and some firms may not change their bad behaviour despite disclosure, in the hope that some participants will remain uninformed. For example, apart from disclosing information to customers, financial institutions may be required to comply with certain risk-mitigating standards to discourage moral hazard. In addition, certification by rating and audit agencies may be required to provide additional comfort.[7]

Restrictions on firm behaviour are needed, but merely proscribing particular actions may not be effective. It is difficult to control bad behaviour directly. However the probability of such behaviour can be reduced by focusing on the removal or reduction of wrong incentives that lead to bad behaviour. Hence regulators require banks to maintain sufficient risk capital to curb reckless lending, and also do not allow insider lending. Because business conditions can change, restrictions should not be too specific. Regulators may require a legislative mandate to enable them to have a broad scope of action. This may involve breaking up firms, or imposing ownership restrictions (as in the case of the Glass-Steagall Act which debarred commercial banks from owning investment banks).

The third category of regulatory instruments comprises Mandates. Through this means, regulators seek to achieve a public purpose without

committing public funds. Mandates are a form of hidden tax on the firms. An example is the mandate on banks to provide "financial inclusion" and lend to "underserved" segments including small farmers and the poor.

In both developing and advanced countries, regulatory institutions have undergone significant changes. In India, independent regulatory institutions are being created particularly in the infrastructure and financial sectors where the roles of markets and private enterprise are increasing, alongside the incumbent public sector firms (which typically functioned as monopolies earlier). These new regulators are expected to replace direct control of markets with government ministries, and ensure a level playing field for private firms and the public sector firms. The initial experience of these regulatory bodies has not been easy or particularly successful (Bhattacharya & Patel, 2005; Rao & Gupta, 2008).[8] These institutions have had to function with inadequate enforcement powers, poor compliance, contend with opposition from incumbent public sector firms, and turf battles with the parent ministries as policymakers. It is clear from this experience that even when the need for regulation is well recognised, the effectiveness of regulatory institutions cannot be taken for granted. Their design must be appropriate for the political, legal, technological, and business contexts in which they operate.[9] To spell out design principles does not of course ensure that these will be adopted. How do regulatory institutions actually evolve? Sen and Suraj (2009) have analysed this question in the Indian context (with special reference to the regulation of competition) in the telecommunications industry. Their explanation is based on a process of political economy in which there are conflicts, negotiations, and manoeuvres by major actors. They identify two key mechanisms for balancing conflicting interests—the political/policy process and the legal process. They show how the regulatory institutions evolve through a series of iterations. They explain how the concept of *public interest* gets periodically redefined as policies change. The legal process plays a crucial role in enabling the regulatory institution's role and jurisdiction to adjust to the new policy and business context. Therefore the emergence of an effective regulatory institutional framework ultimately

depends on the resilience and robustness of the democratic framework and the legal system.

In advanced countries during the globalisation era, despite the strong anti-regulation rhetoric of politicians and the deregulation of the financial sector, the overall actual experience has not been one of unalloyed deregulation. On the contrary, there is evidence that the number of regulatory institutions (both state as well as non-state) have actually increased (Levi-Faur, 2008). Braithwaite (2008) has argued that instead of *laissez-faire* and unfettered markets, the broad trend has been a shift towards "regulatory capitalism" in advanced market economies. There is a symbiotic relationship between the modern mega-corporations and regulation, rather than being completely antagonistic (Braithwaite, 2008). Regulations often strengthen the market power of large corporations vis-à-vis small firms because they are better able to bear the costs of complying with regulations. Large corporations have in fact demanded certain types of regulation that are in their interest. The emergence of regulatory capitalism has been accompanied by innovations in regulation, including the growth of non-state regulatory bodies. For example, in chemical industries where there is danger of serious accidents, self-regulation can be observed. Also, as seen in the Indian case, regulatory institutions need to be (and are) set up by the government in newly privatised industries independent.

"Self-regulation" is particularly interesting from the perspective of corporate governance because of the enhanced role that firms have in these regulatory systems. Self-regulation refers to a regime in which "a group of firms or individuals exerts control over its own membership and their behaviour" (Baldwin & Cave, 1999, p. 125). The advantages of self-regulatory regimes arise from their ability to mobilise specialised knowledge and expertise about the regulated industry. In doing so, they can be relatively more cost-efficient compared to government regulators in formulating rules and standards. Also, they may be better able to secure voluntary compliance from their member firms. There are however, concerns about the accountability of self-regulatory systems, and sceptics fear that they may be easily "captured" by the firms that they are supposed

to regulate.[10] There is a great amount of variability within self-regulation across the public-private spectrum. Institutions can differ depending on the degree to which they fulfil governmental functions—some self-regulatory bodies may pursue mainly the private ends of their members, or they may be fulfilling public policy tasks. The activities of self-regulatory bodies need not be entirely independent of the government. They may be guided and restricted by rules, statutes, and oversight by government agencies. There may also be processes for public enforcement of regulatory rules that have been developed by self-regulatory bodies.

Overall, there thus appears to be a greater degree of recognition and acceptance that regulatory discipline is not something that can be totally or even substantially relaxed if the interests of societies and peoples at large are to shielded from the disastrous consequences even of a partial collapse of economic and financial systems. Not only specific countries but also large parts of the inter-dependent global economies suffer from such fallouts, and hence they cannot be silent spectators to any such breakdowns. We are currently in a period of institutional transition with respect to regulation in many parts of the world. The process is characterised by political and intellectual contestation, as well as legislative action. At the same time, a substantial degree of innovation and experimentation in regulation has occurred. Non-state stakeholders are playing a larger role in this process.

4. Evolution of regulatory regimes in corporate governance

The corporate sector in a country forms an ever increasing component of its economy. It contributes large proportions of the country's national output and employment, and thereby it significantly impacts the society and its environment through its activities and operations. And yet, corporate regulation was virtually non-existent in the early decades of corporatisation. The earliest corporations, such as the British East India Company, were all chartered by royal assent. Apart from the covenants that the charter imposed—which were minimal with regard to public interest and more focused on the benefits to the crown—there were few regulatory restraints on their behaviour. In the nineteenth and early

twentieth century, US corporations were allowed to operate with little restraint. Monks (2010) observes that at the beginning of the "glorious thirty years" from the late 1970s to the final years of the first decade of the new millennium, "It seemed possible that private enterprise could operate on a global stage, free from the constraints of governmental regulation and oversight. The vision was simple and stirring, and in many ways irresistible: Corporate efficiency could co-exist with democracy...Today, we are surrounded by the wreckage of this seemingly noble experiment. 'Self-restraint' proved largely to be no restraint. Rather than legitimatise the power handed them, corporations have ensured the ultimate need for involvement of government and the end of the dream" (p. 1). The scars of the early days of unrestrained capitalism that gave rise to the *robber barons* had been re-inflicted on an exuberant modern society that was gullible all over again. Regulation had to be brought in almost with a vengeance in the USA. In the early twentieth century it was ably conceptualised by Brandeis (1913) to put an end to the "money trust" of investment bankers and the interlocking directorates that led to monopolistic excesses. This was followed by Franklin D. Roosevelt's regulatory efforts after the Great Depression, and in the late twentieth and early twenty first centuries, there was a plethora of restrictive legislation including the Sarbanes-Oxley enactment in 2002, and the much stricter listing covenants ordained by the Securities Exchange Commission and the leading Stock Exchanges. The pendulum had swung decisively in favour of stricter control and regulation of the publicly traded corporate sector.

In the United Kingdom, corporate governance guidelines were strengthened by successive committees headed by Adrian Cadbury, Ronnie Hampel, Richard Greenbury, Derek Higgs and Chris Smith (and David Walker in November 2009 specifically on governance in banks). The UK company law was refurbished and revised in 2006 after a decade of consultations and discussions.

In India, the legislative governance of companies had always followed corresponding developments in the UK at least till the country's political independence in 1947. Since then, a major overhaul in 1956 and

a series of amendments in subsequent years have tightened control over corporate behaviour. A Companies Bill was introduced in parliament in 2009 and is awaiting approval. Listed company governance has similarly undergone a quantum change—since 2000, the listing agreements have been strengthened to seek better governance, transparency, and disclosure among publicly traded companies.

While designing a model of regulation appropriate to the stage of development of the country, it is important to bear in view the twin regulatory objectives of protecting the interests of shareholders (through improved value creation and its equitable distribution) while promoting investment and encouragement entrepreneurial leadership.

Regulatory models and issues in corporate governance

There are several ways to apply regulation to subject entities and ensure their compliance, where necessary by adequate, and even exemplary, punishment. We review three such key themes that appear to be currently in contention, with little consensus on the most appropriate variant that would deliver the desired results. These may be grouped as follows (a) Principle-based vs. Rule-based Governance; (b) the Comply or Explain Approach; and (c) the Resolution of Multi-Regulator Conflicts.

Principle-based vs. rule-based systems approach

This debate concerns whether intended governance standards are better achieved by laying down broad principles or prescribing detailed requirements. Admittedly both the methods have their own advantages and disadvantages. The rule-based system would, for example, clarify precisely what is required. As Ford (2008) points out, “The classic example of the difference between rules and principles or ‘standards’ (to use another term) involves speed limits: a rule will say, ‘Do not drive faster than 55 mph’, whereas a principle will say, ‘Do not drive faster than is reasonable and prudent in all the circumstances.’ Put another way, a rule generally entails an advance determination of what conduct is permissible, leaving only factual issues to be determined by the frontline regulator or decision-

maker. A principle may entail leaving both specification of what conduct is permissible and factual issues for the frontline regulator." (p. 6).[11]

"Rule-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard. This encourages a check-the-box mentality to financial reporting that eliminates judgments from the application of the reporting…[but] rule-based standards make it more difficult for preparers and auditors to step back and evaluate whether the overall impact is consistent with the objectives of the standard" (Herdman, 2002, p. 5). They "promote precision, formal equality, predictability, certainty, uniformity, and judicial restraint...and reduce the likelihood of bias, arbitrariness, and abuse of power by decision makers" (Ford, 2008, p. 7, fn. 24).

Thus under certain circumstances that require precision such as in accounting or actuarial processes, defining the rule of the game in as much detail as possible may actually be helpful to avoid any unintended deviations in application, and consequently the results. On the other hand, Herdman (2002) goes on to say that "An ideal accounting standard is one that is principle-based and requires financial reporting to reflect the economic substance, not the form, of the transaction" (p. 5) and cites some Accounting Standards that combined a judicious mixture of principles and rules that he hoped would serve as a test of the level of specificity needed to strike a balance between rules and principles. Principle-based standards would yield a less complex financial reporting paradigm that is more responsive to emerging issues.

While there seems to be a growing appreciation of the superiority of principle-based approaches over their rule-based counterparts, two important issues need to be addressed—first, which of these approaches best subserves the objectives of corporate regulation; and second, what are the preconditions for their successful implementation.

The experience reported from the UK which has been predominantly following the principle-based approach in corporate governance seems to indicate that the country has benefited from its adoption. It must be

noted though that most of these findings are based on the holistic status of corporate governance in the UK which would include the comply or explain approach and many other facets of applied governance practices in that country, and not just on the principles versus rules issue.

On the issue of the preconditions for the successful introduction of principles-based governance regimes, it is necessary that at least two criteria need to be satisfied. All the players in the corporate governance arena should be willing to go that extra mile to apply the principles in the fullness of their spirit; and secondly, the markets should be alive to the freedom of interpretation and choice provided by the principles to operating managements and should be in a position to evaluate their performance on an informed basis. Ideally, large block holders including institutional investors may take this role on themselves and evaluate company performance on this parameter. This would help in distinguishing the good performers and rewarding them with an appropriate market premium even while penalising those who unwittingly or otherwise fail this test.

There is a need to exercise caution before making a hasty transition to the principle-based approach. Currently in India, the rule-based component dominates the approach to corporate governance regulation, in the form of legislative or regulatory mandates. There is a need for the gradual diminution of these detailed check-box provisions with well thought out principles. The process has to be handled with extreme care and changes should only be made after due public discussion and with the buy-in from all the parties concerned. Even then, such a change can bring in the benefits of improved transparency and investor confidence on the one hand and a substantial reduction of compliance costs to the companies on the other, only if there is a substantial enhancement in the market's capacity to evaluate, and reward or punish the companies according to their performance on the governance scale. Otherwise such an experiment is unlikely to succeed.

The Comply or Explain Approach

The second issue in regulation has to do with the extent of compulsion as opposed to conviction with regard to governance practices. This also

bears upon the extent of self-restraint on the part of the regulators with regard to the extent of freedom they wish to offer to their subjects, and also upon the trust and confidence that the subjects are able to command with regard to their capacity to utilise freedom without allowing it to degenerate into licence.

If the instruments for achieving regulatory objectives could be conceived of as a continuum ranging from inviolable mandates at one end of the spectrum and total volition at the other, comply or explain would be somewhere in the middle, where desired regulatory requirements are articulated but with an option granted to the regulated not to comply so long as the reasons for such non-compliance are explained to the satisfaction of those to whom the entity is accountable.

The UK is probably the one country that has practiced this comply or explain approach successfully for close to two decades.[12] It is recognised in a corporate governance context (FRC, 2006) that "The key relationship is between the company and its shareholders, not between the company and the regulator. Boards and shareholders are encouraged to engage in dialogue on corporate governance matters. Shareholders have voting rights and rights to information, set out in company law and the Listing Rules, which enable them to hold the board to account." (p. 3).

Viewed in this perspective, regulation was seen as a facilitator to ensure that the processes involved in the accountability framework between companies and their shareholders were properly (as laid down in the listing requirements) conducted. If the company chose not to fall in line with any specific requirement on the ground that complying would have jeopardised the competitive wealth-creating capacity of the company (which clearly will not be in the shareholders' interest), it was welcome to default so long as it publicly justified its actions (or inactions). If the shareholders did not agree with the company's decisions, they could punish the company by bringing down its stock prices, and in extreme cases resort to shareholder actions through courts or at members' meetings.

It is also possible to evaluate the comply or explain concept in a regulatory context from an ethical or libertarian viewpoint. The freedom

granted to corporate boards and managements to deviate from the prescribed requirements is concurrently circumscribed by the requirement to "explain" to those affected by such decisions. It is not an unfettered licence to flout the regulation with impunity.

To be effective though, the markets must be sufficiently developed and enlightened enough to see through unworthy defaults and to inflict appropriate retribution. The European Corporate Governance Forum (2006)[13] highlights the preconditions that must exist for the success of this approach as follows. There should be a real obligation to comply or explain; a high level of transparency, with coherent and focused disclosures; and a way for shareholders to hold company boards (unitary or dual) accountable for their decisions to comply or explain and the quality of their disclosures.

A number of countries have embraced the comply or explain concept in varying degrees, including Canada and Australia, but the progress in Europe itself is somewhat slow. In India, the elements of the concept are present in the listing agreements which lay down non-mandatory best practices in addition to mandated requirements *but there is no obligation on the part of companies to publicly explain why they are not following them.* The most recent instance of such efforts on the part of the government was the voluntary National Guidelines On Corporate Governance (2009), again with no requirement for the companies to explain their non-adoption. The value of such initiatives is unlikely to be substantial; in any case, companies which believe in such good practices are likely to be following them, those not interested couldn't be bothered, and the rest are likely to view them as good practices that they would put into place at a convenient time since there were no obligations whatsoever either to implement or to explain why they were not followed.

How does the market react to non-compliance of requirements even in countries like the UK where the comply-or-explain principle has been in place? Recent research (MacNeil & Li, 2005) suggests that despite a substantial proportion of listed companies in the UK (around half the population in 2004) defaulting and in most cases "explaining",

investors did not seem to be unduly concerned so long as their financial performance was good. The central point is that investors seem willing to accept a company's judgement as regards substance (the optimal governance structure) when times are good, but are less (or not) willing to accept it when financial performance is poor (i.e. there is reversion to process). This is all the more disturbing especially in a country like the UK where ownership is generally dispersed, and institutional investors (who reputedly should have the wherewithal to judge governance performance) predominate. One can only speculate what would be the approach of the non-promoter investors in a country like India with predominantly concentrated or dominant ownership and control patterns, further compounded by virtually passive institutional investors with substantial block holdings. If the pace and extent of compliance even with the mandated requirements ever since 2000 when listing agreements were modified to prescribe corporate governance provisions are any indication,[14] the prospects of any successful implementation of the comply or explain model must indeed be quite gloomy.

Multiple regulators

The third issue that impacts the successful operation of the chosen regulatory model concerns the apparently unavoidable presence of multiple regulators with overlapping jurisdictions, often engaging in turf wars among themselves.[15] As economies develop, often in a haphazard manner over decades, it is inevitable that an equally complex web of regulation and supervision gets built over time. Some segments of the economy, such as the financial sector, are more prone than others to the rigours of multiple regulations. Whenever regulations framed by one regulator are directly in conflict (or not fully in conformity) with the regulations of another, difficulties in satisfactory compliance can arise. No country is immune to this continuing phenomenon. Disparate models to address these issues have been tried out around the world with varying degrees of success, and this is indicative of the problems defying satisfactory resolution.

Even for entities operating in just one segment of business, problems can sometimes arise. For example, a listed company engaged only in the

generation and distribution of electricity may have to comply with the regulatory regimes of not only legislation and regulation relating to the industry segment but also with the requirements of SEBI and the stock exchanges, besides those laid down in corporate legislation. The situation is similar in many other cases like banking, insurance, telecommunications, and so on. The complexities do not affect the companies alone, but the regulators as well. Often, especially in emergency situations, the regulators themselves find it hard to hammer out solutions and sometimes have to be arbitrated upon. Paulson (2010) highlights the excruciating and often frustrating confabulations between and among the various regulators and legislative institutions during the sub-prime crisis and the subsequent near-collapse of the financial system in the US in 2008. Besides the Treasury, the regulators involved included the Federal Reserve Board, the Securities and Exchange Commission, the Federal Reserve Bank of New York, and the Federal Housing Finance Agency. In addition, various House and Senate Committees on Finance, Banking, Housing and Urban Affairs, Financial Services, and so on were also involved. Given the overriding need to respect and accord with the independence of the regulators in the US, Paulson (2010) highlights the extreme caution and tact with which the efforts to coordinate the pre-emptive and corrective measures had to be tackled, even while maintaining utmost secrecy to ensure no price sensitive information was leaked out that may have major impact on the stock markets.

Longer term reforms proposed in the US (Paulson 2010, pp. 126–127) comprised three new regulators—a business conduct regulator solely focusing on consumer protection; a prudential regulator overseeing the safety and soundness of financial firms operating with explicit government guarantees or support such as banks; and an omnibus regulator (eventually the Federal Reserve) with wide ranging powers and authorities to deal with any situation threatening the country's financial stability. A separate regulator for government sponsored enterprises (such as Fanny Mae and Freddie Mac) was also to be set up operating under the Federal Reserve.[16] Shorter term measures included (among others) the merger of

the Securities and Exchange Commission with the Commodity Futures Trading Commission.

While opting for a single or super regulator even on a business segment basis may look attractive at first sight, there are inherent problems associated with such concentration of power as well. Such a super regulator, if subjected to political intervention and pressures, may well impact the entire economy and the markets while a system of multiple sectoral regulators may be less prone to such wholesale abuse of power, besides of course bringing to bear upon their work the specialised knowledge and experience of their particular domain. And the experience of countries which had embarked upon a single financial regulator system does not offer any major comfort of success or protection against the kind of problems that gave rise to the 2008 global meltdown.

The UK, which had all along been cited as the prime example of successful single supervisor system country for its financial industry, has now formally decided to wind down and abolish the FSA in 2012, replacing it with three supervisory bodies—a Prudential Regulatory Authority created as a subsidiary of the central bank, a Financial Policy Committee at the bank, and a Consumer Protection and Markets Agency—and strengthening Bank of England's supervisory role.

In the Indian context where a Financial Stability Development Council has been proposed by the government, doubts have been expressed (Patil, 2010) as to the potential erosion of constituent regulators such as the Reserve Bank of India and the possibility of consequential dilution in their accountability.

Even as reservations on the institution of a single super regulator for the financial sector are voiced, its extension to include capital market regulations is a non-starter. Regulators and the regulated need to reconcile to such multiple-domain suzerainty and learn to consult, cooperate, and coexist in a harmonious manner such that while achieving their individual objectives, no unsolvable inconsistencies creep in, thereby placing the regulated entities under strain for compliance. As it is there is a strong

interlocking of regulatory membership on boards and other decision making bodies; it may be worthwhile to develop practical conventions regarding which of the regulators in particular circumstances is the first among equals and defer to their wisdom and domain. Having laid down the domain objectives of the regulators, the government of the day should ensure that no political pressures are brought to bear upon the regulators in day to day implementation and interpretation of laid down policies and procedures. The time-tested method of diffusion of authority and a well-functioning system of checks and balances overseen by an independent judiciary is probably the best bet to ensure regulatory maturity, independence, and constraint.

The success of regulation depends on compliance, but firms obviously have strong short term incentives to avoid and even evade regulation, and to limit the application of regulatory rules that threaten their profits. The recalcitrant attitude of US banks and other financial firms towards regulatory initiatives, even after the 2008 financial crash and taxpayer funded bailouts[17] of unprecedented magnitude is a sharp reminder of this fact. Even as the oil spill from BP's leaking deep sea wells in the Gulf of Mexico threaten to become the worst environmental disaster in history, oil firms have begun strategising against possible future regulation.[18] Thus the preparedness of private firms to fulfil public responsibilities lags behind what might be desirable from a societal standpoint. The question is "Can corporate governance play a useful role in this regard, and if so, how?".

Corporate governance and regulation intersect because both are intended to influence the behaviour of corporate managers. During recent decades, there has been a great deal of debate in response to major corporate failures and scandals of the 1990s. These episodes have frequently been interpreted as evidence of the failure of corporate governance to exercise adequate internal oversight. In the US, important legislation (such as the Sarbanes-Oxley Act 2002) was enacted, and the Securities and Exchange Commission tightened up the rules in relation to listing requirements (Balasubramanian, 2010).[19] Global trends in corporate governance in recent decades have been strongly influenced by the US experience

(Sullivan, 2010). The main aim of corporate governance regulation has been to ensure the adequacy and integrity of corporate disclosure, so that shareholders and investors could make better decisions. Diagnoses of what went wrong in the corporate failures (like Enron or World Com) also highlighted the failure of "gate keepers" (auditors, analysts, and rating agencies). Hence, changes such as greater oversight of accounting firms, strengthening the audit committees of corporate board, and of internal controls (such as CEO certification of financial reports) were introduced. The underlying principles of these reforms are based on the "shareholder theory of the firm" (and a principal-agent relationship between the owners and managers), according to which managers must perform exclusively in the interests of shareholders. Although corporate capitalism especially in the US and the UK have been based on shareholder primacy right from inception, during the 1960s and 1970s the relative power of professional managers had increased markedly. Structural changes within capitalism contributed to this trend towards reassertion of shareholder rights in the late twentieth century. In particular, there was a rise in importance of the finance industry, accompanied by the increasing asset preference of households to hold savings in stocks and bonds. This gave a fillip to the growth of institutional investors such as pension and mutual funds. Powerful networks of investment and other bankers,[20] private equity executives and institutional investors were forged. A struggle ensued between shareholder groups wanting to exercise rights of ownership and the top managements seeking the professional right to manage. In this context, a more active market for corporate control emerged. At the same time, the compensation of senior executives became linked to the market valuation of the company's stocks. These trends were important in entrenching and advancing the principle that 'maximisation of shareholder value' was the primary role of management. This formulation constituted a compromise that was acceptable to shareholders as well as to the top management of firms. However, it did not address the larger issues concerning the relationship between the firms and other stakeholders, including society as a whole.

The 2008 financial crash and the environmental disaster in the Gulf of Mexico have dramatically highlighted this weakness. Not only has regulation failed, such events also show that corporate governance structures and processes cannot ensure that firms act more consistently in the larger public interest. In the pursuit of profits, shareholder value maximisation and executive compensation, firms have been taking high risks, particularly of a kind that affects not only shareholders but also other stakeholders. Companies which have become "too big to fail" because this can create massive financial or environmental disasters, assume high risk because they know that governments will step in to bail them out if things go wrong.[21] As shown by the 2008 sub-prime home mortgage crisis, the risk may be shifted not only to governments, but to other market participants to an extent that can have disastrous consequences for the financial system. Firms appear unwilling or unable to act in a manner consistent with their own long term interests, and indeed have endangered the health of the market system as a whole. Thus, a major lacuna exists with regard to systemic risk that present systems of oversight and incentives are not able to reduce sufficiently.

5. Finding the golden mean: To regulate or not to regulate?

The answer lies in a better alignment of self-regulation mechanisms with corporate governance. This would mutually reinforce their strengths and would provide a more sound institutional foundation for market systems. For this alignment to occur, two types of institutional changes are desirable. First, the paradigm of corporate governance should shift towards the *stakeholder model* from the shareholder model. Second, the design of regulation should shift towards a hybrid form that combines *self-regulation* with *co-regulation*. This implies a combination of self-regulation (which includes the participation of other non-governmental bodies) combined with the participation of the government particularly in enforcement (Balleisen, 2010). There should also be a change in *regulatory strategy.* It should move from "ex-post regulation" towards "ex-ante regulation". In other words, *pre-emption* and *prevention of bad outcomes* should get

more attention rather than the punishment of bad behaviour by firms after it has occurred (although the latter is also important). The key challenge of regulatory design is to find the right balance.[22] A co-regulation model opens the possibility of a golden mean that would be able to pursue this objective more effectively because of its participatory character. These institutional elements are not new. Co-regulation models of regulatory design have been developed extensively in Australia. Stakeholder models of corporate governance have historically existed in continental Europe and Japan (the so-called "Coordinated Market Economies"), whereas the Anglo-American model of capitalism ("Liberal Market Economies") has tended towards the shareholder model (Hall & Soskice, 2001). In India, corporate governance initiatives have evolved in parallel with market reforms. A key objective has been to align financial markets with practices followed elsewhere, so that foreign institutional investors are better able to judge Indian companies.[23]

Self-regulation initiatives in the past have not been effective because many corporations have used them as "smokescreens" to deflect serious regulatory oversight (Balleisen, 2010). Corporations too often treat regulations cynically as constraints and irritants that have to be managed and overcome along the route to realising shareholder value maximisation. The outcome of such conduct has not been happy—the social standing and image of corporations in the advanced countries today is very low. The important question therefore is whether corporate governance can help change the short-sighted attitude and narrow mindset of corporations. Balasubramanian (2010) has proposed a stakeholder governance framework that recognizes the broader social context in which a firm functions and the related responsibilities of the firm. Corporate boards and executives are answerable to and/or guided by government legislation, market regulators, lenders and creditors, institutional investors, stock exchanges, shareholders/stakeholders, as well as the press and media. Balasubramanian (2010) has argued in favour of a re-orientation of corporate goals away from the narrow goal of *profit maximisation* toward *profit optimisation* through a process of building *corporate reputation*. Such a corporate vision would provide a stronger motivation for firms to define their relationship

with the wider network of stakeholders. A strong reputation would better serve the long term interests of corporations. Drawing on stated corporate principles proposed by respected business conclaves and followed by some leading firms, Balasubramanian (2010) explains how firms could build their reputation on the following "pillars"—integrity, trust, ethics, social responsibility, philanthropy, transparency and communication, and citizenship.[24] If such principles are adopted widely and become accepted norms of corporate conduct, the world would be a better place and the task of regulation would certainly become much easier. The challenge lies in creating governance processes and systems that offer sufficient motivation and incentives for the firm's decision-makers to act responsively to wider stakeholder concerns.

Stakeholder-oriented reputation building values would make it easier to *align the internal governance of firms with regulatory governance.* In particular, the effectiveness of co-regulation would be enhanced. As noted earlier, different variants of nongovernmental regulation have been attempted in many countries. Nongovernmental regulation has several potential advantages. These include greater flexibility and precision because of the greater access to relevant knowledge of the particular business, greater coverage, better cooperation between regulators and regulated firms, and consequently a greater "buy-in" by the regulated firms. However, the experience has not always been successful. Private regulation works relatively well under certain conditions (Balleisen, 2010). These include situations in which firms within an industry have an economic interest in having regulation. The potential benefits may include reduction of economic uncertainty, efficiency increases through having common standards or by enhancing the ability of the industry to protect its reputation. Private regulation also works well when there is a high degree of heterogeneity among firms in the industry, so that universal standards are not feasible. In such cases, mechanisms that permit collaboration between managers and regulators are efficacious.

For private regulation to be effective, transparency and accountability are very important. In this context corporate governance systems can be

highly supportive. The firms can, for example, collect data required for monitoring regulatory compliance, and disseminate them throughout the organisation, and the entire industry. Firms can strengthen internal regulatory systems in several ways. Formation of monitoring teams that include workers' representatives is a useful step in effective self-regulation. The clout of internal regulators within the corporate organisation needs to be enhanced. This can be done by allocating sufficient budgets for their information collection and monitoring functions, and by providing them direct access to topmost levels of management and boards of directors. Similarly, the achievement of regulatory goals by employees should be measured, and this should be part of their performance evaluation. Third party rule-making and monitoring can provide additional accountability and rigour to compliance. These third parties could be industry associations and well as public interest groups. Finally, the direct participation of government is needed to bolster the enforcement of regulatory rules.

An impressive body of analysis and experience has developed reflecting the renewed interest in co-regulation. Drawing on this, Balleisen (2010) has proposed a useful list of actions that government regulators could undertake within a "co-regulation" framework. Government regulators could (1) mandate appropriate reporting requirements for internal regulatory plans of firms, and ensure that non-state regulators carry out specific assessments; (2) publicise the regulatory performance of firms, thereby linking regulatory compliance with corporate reputations;[25] (3) create a professional body of nongovernmental regulators;[26] (4) enhance the capacity of government regulators to analyse and evaluate the impact of private regulatory governance;[27] (5) periodically inspect self-regulated firms in depth and ensure that standards are actually met; (6) ensure that certain "regulatory floors" are maintained, and that violators punished along a graded schedule in keeping with the extent of violation; (7) empower supplemental nongovernmental watchdogs to leverage greater expertise and information; and (8) maintain a credible threat that administrative regulation will follow if self-regulation fails.

To sum up these arguments, an effective co-regulation framework can be developed on the basis of the above principles which will provide

an overarching framework of policy and credible incentives that support self-regulation. Thus the weaknesses of stand-alone self-regulation (that have rendered them ineffective in the past) could be avoided, and its useful features harnessed. In addition, this type of regulatory framework would be synergistic with stakeholder oriented corporate governance that aims at building a reputation for the firm.

Regulatory compliance depends on the willingness of the regulated firms to cooperate. We have proposed a particular institutional framework that combines corporate governance and regulation in a synergistic manner. These two institutions of governance—regulation in general and corporate governance (one a subset of the other)—in particular need to be considered together because they impinge on each other. The corporate governance model influences the firm's motivation and hence regulatory compliance. The dominant paradigm of shareholder-linked corporate governance is not very conducive to regulatory compliance due to its narrow concern. The adoption of a stakeholder model of corporate governance would be more amenable to generating internal incentives for regulatory cooperation, and hence compliance. In particular, the corporation's reputation building model as proposed by Balasubramanian (2010) has the potential for legitimising within the firm, a synergistic relationship between wealth creation and regulatory compliance, leading to improved investor trust and stakeholder approbation. On regulation *per se*, a hybrid model of regulation is best in this context. In particular, a model that combines nongovernmental regulation with governmental participation (co-regulation) would be the most effective, avoiding as it does the motivational pitfalls of pure self-regulation. Moreover, this regulatory framework would provide the institutional foundation for the seamless integration of corporate reputation-building plans with achieving the public goals identified by regulation. Firms, alongside other actors such as industry associations, citizen groups and professional societies, could develop appropriate regulatory rules within a transparent and accountable framework. The firm's internal processes for data collection and monitoring could be strengthened. Firms could ensure adequate incentives within the

firm for regulatory compliance by linking relevant parameters to measures of employee performance. Government policy makers and regulators on their part could put in place a set of processes (mentioned above) for credible enforcement, including systems for rewarding firms based on their performance on selected indicators of regulatory compliance.

We have sketched very briefly the essential contours of a corporate governance cum regulatory framework. While not universally applicable, it has relevance in industries where there are problems of information asymmetry, technological complexity and rapidly changing business and technology conditions, and potential for high systemic risk. In these contexts, collaborative and participatory approaches allow for collectively developed, jointly monitored and pre-emptive (*ex-ante*) types of governance. The actual form of regulatory organisation and the mix of instruments and incentives would be context-specific and should emerge from a process of trial and experimentation.

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Notes

[1] This massive epic dated at around 500 BCE documents the origins, conduct and consequences of a massive fratricidal war between two branches of the Bharata clan, and is a mine of good counsel and political stratagems which are of continuing value. For a secular and modern interpretation, see Doniger (2009) and Das (2009).

[2] See "Timeline: Sub-Prime Losses: How Did the Sub-Prime Crisis Unfold?", BBC News. Accessed on 25 august, 2010 (http://news.bbc.co.uk/1/hi/business/7096845.stm). Soros (2008) also sets out the detailed listing of events and interventions commencing on 6 August 2007.

[3] For a report on the current political activity concerning financial reform bill in the USA, see "Maul Street: Bit by bit, things worsen for the financial industry", The Economist, May 15-21, 2010, pp 84-85. Some of the proposals in the Senate legislation are "draconian", and include for example a ban on banks operating a derivatives swaps desk.

[4] The Washington Consensus (a term coined by J. Williamson) was not based on any formal accord; it was rather the intellectual distillation of a set of policy prescriptions for freeing markets from discretionary government intervention. The main elements of the Washington Consensus market liberalisation policy agenda were the following: fiscal discipline, reallocation of public expenditures towards areas where private markets typically failed (health, education, infrastructure), tax reform towards lower marginal direct rates and simplification of indirect taxes, liberalisation of interest rates, competitive exchange rates, liberalisation of international trade and foreign investment, privatisation, deregulation, and secure property rights (Rodrik, 2004; Williamson, 2004).

[5] See Friedman (1982) and Hayek (1994).

[6] In the former case, the price mechanism cannot allocate resources efficiently because it is difficult to exclude those who do not pay from consuming the public goods. Those who pay and those who do not pay for the good can derive the same benefit from its supply. Thus the incentive to reveal one's preference is distorted. In the latter case, private and social benefits and/or costs diverge. The market outcome based on the maximisation of private net benefits leads to either undersupply or oversupply of the good compared to the social optimum. The standard example of negative externality is when pollution occurs but the polluter does not bear the cost.

[7] However, the repeated failure of credit rating agencies and accounting audit firms in recent crises has shown that their effectiveness cannot be taken for granted. Poor judgement by these agencies needs to be prevented by regulation blocking relationships (between the rating agency and the firm being rated) when there is conflict of interest.

[8] The new regulatory institutions include the Securities and Exchange Board of India (SEBI), the Telecommunications Regulatory Authority of India (TRAI), the Insurance Regulatory and Development Authority (IRDA), the Central Electricity and Regulatory

Commission (CERC), the State Electricity Regulatory Commissions (SERCs), the Petroleum and Natural Gas Regulatory Board (PNGRB), and the Tariff Authority for Major Ports (TAMP).

[9] The Planning Commission's Approach Paper on Regulation spells out some of these design principles. (*Approach to Regulation of Infrastructure,* http://infrastructure.gov.in/pdf/approach_to_regulation_of_infrastructure.pdf).There should be a separation of functions between the regulator and other authorities (legislature, executive and judiciary), and market participants with regard to policy making, framing legislation, rule making and ownership of the enterprises. There should also be adequate democratic accountability for the regulator (to Parliament and to citizens). *The 13th Report of the Second Administrative Reforms Commission* has also made similar and more specific recommendations. Notable among them are the guidelines for improving the interface between the government and the regulator, and for greater transparency and involvement of citizen groups and professional organisations in regulation. They have also called for periodic regulatory impact assessments, and for parliamentary oversight and external review mechanisms to ensure that regulators are accountable.

[10] Stiglitz (2010) for example, states "There is peculiar variant of regulation that has become popular in the United States, self-regulation, which I view as an oxymoron" (p. 27). In the case of banks, they have proved ineffective.

[11] Ford (2008) draws upon Kaplow (1992).

[12] When the recommendations based on the 1992 Cadbury Report on the Financial Aspects of Corporate Governance were incorporated in the listing agreements between London Stock Exchange and the listed companies, a provision was inserted in the agreements stipulating that companies should report whether they had followed the recommendations, or if not explain why they had not done so; this eventually became known as the 'comply or explain' approach.

[13] The European Corporate Governance Forum was set up by the European Commission in October 2004 to examine best practices in Member States with a view to enhancing the convergence of national corporate governance codes and providing advice to the Commission.

[14] For example, several companies (including many state-owned enterprises) are still non-compliant with the mandates requiring induction of independent directors on their boards, and business lobbies successfully delayed the implementation of requirements based on the recommendations of the Narayana Murthy Committee.

[15] The stand-off in 2010 between the Securities and Exchange Board of India and the Insurance Regulation and Development Authority on jurisdictional domain over Unit-linked Insurance plans with significant equity content, issued by insurance companies is a case in point.

[16] These recommendations were made in a 31 March 2008 document titled, *Blueprint for a Modernized Financial Regulatory System,* brought out by the US Treasury. A Bill largely incorporating these recommendations was going through Congressional approval processes as of June 2010. A reconciled draft legislation incorporating consensus provisions of the earlier House and Senate versions was finalised in early July 2010 (Dodd-Frank Conference Report [H.R. 4173], 'Dodd-Frank Wall Street Reform and Consumer Protection Act), preparatory to the processes involved in its Presidential

approval. A fuller discussion of these recommendations and provisions is outside the scope of this paper.

[17] These actions were not widely supported by the American public. Paulson (2010, p. 234) counselled presidential candidate John McCain to refer to bailouts as “rescues” and “interventions” in his campaign speeches.

[18] See “Oil companies weigh strategies to fend off tougher regulations”, New York Times (June 2, 2010). Accessed on 25 August, 2010 (http://www.nytimes.com/2010/06/03/us/03lobby.html).

[19] Balasubramanian (2010) also provides exhaustive references to the literature. Also see Goswami (2010) for a short narrative account of the Indian case.

[20] See Brandeis (1995) for a discussion of the earlier phase of their emergence. After the Great Depression however, the relative importance of the finance industry had declined as manufacturing drove the growth process for three decades. In the globalisation era post-1980, there has once again been a resurgence of the finance industry. The oil shocks of the 1970s triggered this process by bringing petrodollars into the multinational banks.

[21] This may not actually be the case as far as shareholders were concerned. For example, Paulson (2010, p. 170) asserts that “common shareholders had lost nearly everything” in the case of Fannie Mae and Freddie Mac, the two massive mortgage-infected, over-extended US Government Sponsored Corporations that were bailed out; and in case of BP, shareholders had to forego their dividends to enable the company to foot the $20 billion cleanup bill that the Obama administration had imposed (“BP agrees to $20 billion fund for gulf oil spill claims”, Washington Post, (17 June, 2010)).

[22] Both types of regulatory strategies have their strengths and weaknesses. Too much of ex-post regulation can be intrusive and hinder dynamism, whereas too much of ex-ante regulation may be ineffective in containing systemic risk.

[23] The Confederation of Indian Industry has played a key proactive role, in cooperation with SEBI, and the Ministry of Corporate Affairs in promoting corporate governance reform.

[24] Balasubramanian (2010) refers to the Caux Round Table Principles, the Global Compact, the Sullivan Principles, the Tata Code of Business Conduct, as well as scriptural ethical principles (pp. 382–383).

[25] As Balleisen (2010) notes, such information would also be useful for insurance companies, and have an impact on the firm’s insurance costs. This would be an additional pecuniary incentive for regulatory compliance.

[26] This has been done by the Australian Competition and Consumer Commission.

[27] Regulation must change with the changing context. It is essential for government regulators and policy makers to have the capacity to analyse the rapidly changing business and technology environments, so that adjustments in regulatory design can be made as required. It is possible that an industry that has been functioning under direct administrative regulation requires to be regulated through a co-regulation mechanism, and vice-versa.

4

Progress, Unfinished Business, and the Rewards of Corporate Governance Reform in Asia

Jamie Allen

1. Introduction

Considerable progress has been made in corporate governance reform in the Asian region since the regional financial crisis of 1997–98. Tangible improvements can be seen in many countries in areas such as corporate reporting, board composition and effectiveness, shareholder rights, accounting and auditing standards (and practices), and regulatory enforcement of securities laws and listing rules. The quality of corporate governance does vary markedly between, and within, countries, yet almost all have moved forward.

Looking ahead, what are the major areas of unfinished business in corporate governance reform? What further regulatory reform is required? To what extent are shareholders—both institutional and retail—exercising their rights, and what challenges do they face in doing so? Why have so few listed companies in each market built a strong reputation for good governance (with the winners of corporate governance awards often being the "usual suspects")? Is the government showing leadership to the corporate sector by fighting internal corruption and public sector mismanagement?

This paper will argue that these issues need to be addressed in order to reduce investment risks and to raise the quality of capital markets around

the region. Although the consequences of doing nothing may be hard to discern over the short term—especially during market booms—failure to act on the part of governments, regulators, companies, investors, and intermediaries will be counterproductive over the longer term. The more successful markets are those that balance the interests of the supply side (issuers, investment banks, and other intermediaries) with the interests of the buy side (investors, and broader society in general). Despite emotional warnings that over-regulation would kill markets, the history of the past decade or more in Asia has been one of steadily increasing regulation in corporate governance and expanding capital markets. The one exception (Japan) is also the market with the most ambivalent policies on corporate governance.

The rest of the paper is organised in two parts. The first briefly documents the progress made in the Asian region on the corporate governance front, while the second identifies the key themes where more work remains to be done.

2. Progress in Asian corporate governance: 1998–2010

As would be expected given the differing levels of industrialisation, capital market development, and government transparency/corruption around Asia, the quality of corporate governance varies considerably between markets. Table 1 provides a macro assessment of the state of corporate governance in 11 Asian markets in 2007.

Table 1: Market rankings of corporate governance quality in 11 Asian markets

Rank	Market	Rules & Practices (%)	Enforce (%)	Political & Regulatory (%)	IGAAP (%)	Culture (%)	Total Score (%)	2005 (%)
1	HK	60	56	73	83	61	67	69
2	Singapore	70	50	65	88	53	65	70
3	India	59	38	58	75	50	56	61
4	Taiwan	49	47	60	70	46	54	52
5	Japan	43	46	52	72	49	52	–
6	Korea	45	39	48	68	43	49	50
7	Malaysia	44	35	56	78	33	49	56
8	Thailand	58	36	31	70	39	47	50
9	China	43	33	52	73	25	45	44
10	Philippines	39	19	38	75	36	41	46
11	Indonesia	39	22	35	65	25	37	37

Source: ACGA & CLSA Asia-Pacific Markets, 2007.

The total scores fell between 2005 and 2007 in most markets not because the quality of corporate governance declined, but because the survey methodology became somewhat tougher.[1]

Despite the different rates of progress between markets, it is possible to assert that all jurisdictions in Asia have witnessed some degree of tangible improvement in governance standards and practices since the late 1990s. Much of the focus of early reforms was on enhancing corporate accountability to shareholders by introducing an independent element (in the form of independent directors) into company boards, and encouraging them to function more effectively through the adoption of board committees, especially for audit. Table 2 and Table 3 show the extent of change from 1997 to 2008.

Table 2: The state of corporate governance in Asia in 1997

Country/ market	Was there an official code of best practice?	Did the idea of "independent director" exist?	Did the idea of audit committee exist?
China			
Hong Kong	Yes (but very short)	Yes	Yes
India			
Indonesia			
Japan			
Korea			
Malaysia		Yes	Yes
Philippines			
Singapore		Yes	Yes
Taiwan			
Thailand			

Source: Asian Corporate Governance Association.

Table 3: Corporate governance in Asia in 2008

Country	Date of main codes	Are independent directors required?	Are audit committees required?
China	2002/2005	Yes	Yes
Hong Kong	1993/2004	Yes	Yes
India	1999/2005/2007	Yes	Yes
Indonesia	2001/2006	Yes	Yes
Japan	(2003)/2004	Optional	Optional
Korea	1999/2003	Yes	Yes (large firms)
Malaysia	2001	Yes	Yes
Philippines	2002	Yes	Yes
Singapore	2001/2005	Yes	Yes
Taiwan	2002	Yes (certain firms)	Yes (certain firms)
Thailand	1999/2006	Yes	Yes

Source: Asian Corporate Governance Association.

The nature and history of the legal regime of governments (i.e. common law derived from Britain vs. civil law derived from Continental

Europe) is not the determining factor in whether governments require listed companies to appoint independent directors; it is an internal policy decision in response to the demands of the international capital markets. Both China and India mandate independent directors, yet have quite different legal systems and company law. Company law in China is closer to that in Japan and Taiwan, yet all three places take quite different approaches to independent directors and audit committees. Whereas Beijing made a conscious policy decision in the early 2000s to move towards global norms on these aspects of modern board governance, Taiwan has gone only halfway (only certain listed companies are required to adopt these standards), and Tokyo resisted all demands for a single standard on board independence until very recently (and even then did not fully commit itself).[2]

Other early reforms around Asia brought about improvements in the frequency and speed of financial reporting (i.e. quarterly reports, and shorter deadlines for annual and interim reports), the amount of detail required in financial reports, and brought in requirements for more disclosure on director share dealings. All jurisdictions in Asia now require some form of quarterly reporting for their main board listed companies, with the exception of Hong Kong.

Significant changes have also been seen in accounting policies and standards, auditing standards, and the regulation of the audit profession. All Asian markets have already adopted or are moving towards full (or almost full) adoption of international accounting standards. Hong Kong and Singapore are leading in this process, with other markets at varying stages of convergence. The most dramatic change occurred in 2006, when China announced that it would move immediately towards adopting IFRS. As for auditing, CPA industry bodies in all major Asian markets are members of the International Federation of Accountants (IFAC), based in New York, and follow its international standards on auditing.[3]

Differences remain however, in the regulation of the audit profession. Some Asian governments have followed the lead of the US, the UK, and the European countries in setting up independent statutory bodies to

supervise the work of CPA firms, and to sanction them for transgressions. This is reflected in the fact that several Asian jurisdictions are members of the International Forum of Independent Audit Regulators (IFIAR)[4], including Japan, Korea, Singapore, Sri Lanka and Taiwan. IFIAR was formed in 2003 with membership open only to audit regulators that are truly independent of the profession they regulate. It is understood that China is seeking to join IFIAR, while Hong Kong and India are not eligible to become members because their primary audit regulator—the local CPA industry body in both cases—is not independent of the profession.

Non-regulatory dimensions

Although governments and financial regulators (including stock exchanges) have been the main drivers of corporate governance reform in Asia over the past decade, other groups have played catalytic roles as well. They include (in rough chronological order of appearance on the reform scene) retail shareholders, professional associations (like institutes of directors), non-profit organisations, and institutional shareholders,

Far less constrained and conflicted than institutional investors, retail shareholders in several Asian markets became active proponents of better corporate governance soon after the financial crisis of the late 1990s. They included maverick individuals and organisations such as David Webb in Hong Kong, Professor Hasung Jang and his PSPD-PEC group in Korea (now known as Solidarity for Economic Reform)[5] , and David Gerald and the Securities Investors Association (Singapore) (SIAS) in Singapore. A little later new retail shareholder groups were also formed in Malaysia and Thailand (with support from the government in both instances, as was the case in Singapore). India also boasts a number of retail shareholder groups, the main difference from the rest of Asia being that these are largely city- or state-based, rather than national.

An early development in the professional sector was the creation of new institutes of directors (IODs) and formal director training courses. Hong Kong reconstituted and rejuvenated its IOD after China regained sovereignty in 1997, while Indonesia, the Philippines, Singapore and

Thailand all formed institutes around 1999–2000 (with help from the Australian Institute of Corporate Directors in the case of Thailand). Company secretarial associations have also been active promoters of corporate governance education, especially in Hong Kong, India, Malaysia and Singapore, while collaborative links are growing between some of these organisations—for instance the Hong Kong Institute of Chartered Secretaries has a representative office in Beijing and works closely with its counterparts in China.

Asia is also home to a range of civil society and/or independent non-profit organisations working in this field. The Japan Corporate Governance Forum (JCGF) published one of Asia's first best-practice guidelines in 1998. The Asian Corporate Governance Association (ACGA) was incorporated in Hong Kong in 1999, initially to undertake research and educational work in corporate governance across the region; more recently it has taken on an advocacy role as well. The Forum for Corporate Governance in Indonesia (FCGI) was formed in early 2000, followed a few months later by the Indonesian Institute for Corporate Governance (IICG). In 2002 the Taiwan Corporate Governance Association (TCGA) was established, and in 2004 the National Foundation for Corporate Governance (NFCG) began operations in India. Unlike the former organisations, however, both TCGA and NFCG were created with an element of government support.

With some notable exceptions (such as Mark Mobius of Templeton Asset Management), institutional investors came later to the party than other non-official groups due to several inhibiting factors such as a historic lack of involvement in basic governance activities like voting, and the lack of internal resources to support such time-consuming exercises; a strong belief among many that they should not intervene in management (the "vote with your feet" mentality); conflicts of interest within financial institutions that placed the interests of the company's investment and corporate banking arms above those of its mutual fund or investment management divisions; and a willingness to free ride on the activities of the few investors who were promoting corporate governance. Investors would also use the excuse that the voting of shares was pointless given

the concentrated ownership structures of most Asian listed companies and their family- or state-owned pedigree (i.e. they could not win a vote, so why bother?).

From 2003–2005 onwards the situation began to change. Some global investors started voting their shares in larger numbers. Many had been voting for years in Japan, where they had their biggest holdings in dollar terms, and they extended this to other parts of Asia such as Hong Kong, Korea, Singapore, Taiwan and Thailand. They began investing in creating dedicated corporate governance teams to manage their voting, and this in turn led to engagement with companies. They also devoted more time and resources to visiting the region in person. Meanwhile, among domestic institutions, certain state pension and investment funds—notably the Thai Government Pension Fund and the Employees Provident Fund of Malaysia—started to signal an interest in corporate governance.

These trends have intensified over the past five years. While hard data is not available, the volume of voting has clearly increased around Asia, as has the level of resources being invested in this activity.[6] The willingness of global investors to spend time in the region engaging with companies, joining fact-finding delegations, or meeting with regulators has also undergone a transformation.[7] And domestic investment managers in different countries, especially China, Japan, Korea and Thailand, are also voting in greater numbers (in part because in some counties, such as Korea and Thailand, they are required to by regulation).

A relevant question is to what extent investors and other non-official actors have positively shaped corporate governance regulation in Asia over the past 12–13 years (as opposed to limiting themselves to more general roles such as education and raising awareness). And to what extent have investors directly shaped company behaviour?

There is little evidence to suggest that investors and civil society groups had much impact on regulation in most countries during the first five years after the Asian financial crisis (1998–2002).[8] This was a period when governments and financial regulators either were under pressure

from international organisations such as the IMF, and/or were competing to prove their international credentials by adopting global standards of corporate governance. It was also a time when the influence of non-official organisations was limited by their own lack of experience, capacity, and following.

During the next five years (2003–2007), a different picture started to emerge. Retail investors and others interacted more with regulators, sought to influence the shape of regulation, and tried to encourage regulators to take their enforcement role more seriously. Although successful to some degree, these changes need to be seen in context. In most public consultation exercises, the voices of the more conservative local business leaders and listed companies (supported by their financial and professional advisors) tended to drown out the voices of other stakeholders, especially minority shareholders. Participation of institutional investors in regulatory consultations remained woefully low, while traditional investment industry associations (such as mutual fund bodies) made a conscious decision to remain quiet again due to the conflict of interest problem—many mutual fund managers are owned by big banks that do not wish to offend their major clients by publicly supporting stricter corporate governance norms. The contribution of some professional bodies (directors, company secretaries) was not always constructive. Although ostensibly formed to promote higher standards of corporate governance, some groups took a conservative and often negative view on certain new reforms (e.g. quarterly reporting, tighter rules on private placements and share pledges, according more power to the regulator).

The unsatisfactory aspect of this was that governments and financial regulators tended to be unduly influenced by those who “shouted loudest” (i.e. vested business interests) and those who were “standing nearest” (i.e. local interests). Few of them seemed to have a clear and consistent philosophy of regulation that guided how they dealt with different situations and balanced competing views. Too often compromises were made for short-term, political reasons.

While this dynamic remains real in Asia, the past two to three years (2008–2010) have brought certain new and more productive developments.

As a result of advocacy work carried out by institutional investors and some non-profit organisations (including ACGA) the rules governing some aspects of shareholder rights have been amended. One key area relates to voting at shareholder meetings—a fundamental right of shareholders, and an important way for them to engage with company management. Obstacles to efficient and transparent voting in Asia (as in many parts of the world) are rife; yet investor pressure has brought positive changes to rules on vote counting in Hong Kong, the earlier release of final meeting circulars in many markets, more translation of meeting materials and the de-clustering of meeting dates in Japan and Taiwan, and the publication of voting results in Japan.

Not all improvements have occurred as a result of rule changes. Market pressure has also managed to persuade companies to take voluntary steps to improve the transparency of their meetings. Companies in Hong Kong began voting by poll[9] several years before it became mandatory in 2009, while leading companies in Singapore and Taiwan are just starting to vote by poll. Top companies in China and Thailand also routinely vote by poll, though more as a result of encouragement from regulators than investors.

Indeed in certain respects, the ability of investors to inspire voluntary action on the part of companies is greater than their ability to achieve regulatory change. The answer to the earlier question regarding the extent to which investors have directly shaped company behaviour is that investors have probably had a greater impact than is generally appreciated. There are direct examples: companies voluntarily limiting the size of private placement mandates in Hong Kong and Singapore because they know that their shareholders do not like excessive dilution. They know this because shareholders vote against these mandates at every AGM, and while companies rarely lose the vote, the number of “against” votes is high enough to attract the attention of the management (which is a fitting rejoinder to those institutional investors who claim there is no value in voting). There are also indirect examples of investor influence: companies voluntarily improving the quality of their financial reports in order to communicate more effectively with shareholders.

Not surprisingly, these arguments need to be qualified. Companies in Asia that respond well to investor pressure on corporate governance tend to be the type of enlightened and better managed blue-chip firm with a large foreign ownership base that would be expected to respond well. Such firms account for a small percentage of all listed companies in any market. In other words, investors have yet to have a significant impact on the vast majority of smaller, less well-managed, and more parochial issuers.

A second caveat is that investors are not a uniform and homogeneous group. Not only does the industry divide into mainstream and alternative asset managers, short vs. long/short vs. long funds, value vs. growth funds, short-term vs. longer term investors, and so on, but the views of investors on the value of corporate governance to their investment process also differ widely, as does their willingness to spend money trying to engage with companies. At any point in time, the management of a listed company (especially one with a large following) is likely to face diverse and conflicting signals from the market. Investors who truly care about corporate governance make up a minority by number in this mélange (in the view of ACGA). Their challenge is to encourage management teams to listen to their constructive comments about governance and ignore the cynical silence from most of the industry.

3. Unfinished business

As the discussion above indicates, there are numerous areas where Asian corporate governance reform remains incomplete. This section touches upon some of the major areas where further work is necessary in most markets.

Corporate reporting

While it is not true that the governance standards in the more developed Asian markets are behind those in developed Western markets in every respect, one noticeable area of weakness in the region is the quality of continuous disclosure—the prompt disclosure of material price-sensitive information. All regulators in Asia have enacted rules requiring

listed companies to disclose news that could have a material impact on share prices, yet it would be fair to say that no market has yet created a robust culture of such disclosure (although there are exceptions at the company level).

Continuous disclosure became a bigger issue when stock prices collapsed over 2007–2008, and investors suddenly discovered that companies had problems they did not know existed. A good case in point was the huge money-losing derivative contracts that several listed PRC (People's Republic of China) firms in Hong Kong had entered into with investment banks before the global financial crisis. The issue also becomes a point of discussion every time a company scandal occurs and investors ask why they were not forewarned. Recent problems in Singapore regarding the failing businesses of some S-chips (locally listed PRC firms) caused anger among investors and embarrassed regulators.

The frequency of governance failures in many markets gives the lie to the idea that disclosure alone can be sufficient protection for investors (a concept strongly promoted by many regulators during the past decade). Firstly, the quality of disclosure has yet to reach the stage in any market where investors have a full and true picture of most listed companies. Secondly, a genuine disclosure-based regime needs to be matched by the robust enforcement of listing rules, company law, and securities laws—something that no Asian market is close to achieving.

Other aspects of corporate disclosure that need work include the speed of reporting (some markets have long deadlines for releasing interim and annual results), the quality of financial reports (even among blue-chips, the quality of reports can vary)[10] , and the quality of non-financial disclosure.

In essence, the challenge for governments, regulators, investors and enlightened companies in Asia is to create a culture where transparency is seen by businesses as a strength, not a weakness. While data on the governance quality of companies is somewhat limited in the region, recent surveys all tend to point in the same direction—that the market does recognise and reward (at least over the medium to long term) companies that are seen to be more transparent and better governed.

One of the few stockbrokers in the region to regularly track corporate governance is CLSA Asia-Pacific Markets.[11] Data from CLSA's company analysis in recent years indicates a link between high corporate governance scores, higher return on equity (ROE), and higher price-to-book (PB) ratios. In CLSA's sample of 536 listed Asian firms, the average ROE for the fiscal year 2009 was 18%, and the average PB ratio was 2.8 times. However companies that scored 75% or above in CLSA's corporate governance survey had an average ROE of 23%, and traded at an average PB of 3.9 times.[12]

A recent study of 692 listed companies in 10 Asian markets by UBS (the Swiss investment bank) found that the share prices of companies with better governance tended to outperform those with worse governance (UBS, 2009). As Table 4 shows, the average returns of a portfolio of stocks ranked highly on corporate governance criteria clearly outperformed those ranked poorly over one, two, and three years in four different markets (the one exception being Hong Kong over one year).[13] Not surprisingly, better governed companies tend not to outperform significantly over the short term (three to six months), except in Taiwan (UBS, 2009).

Table 4: Corporate governance portfolio returns

	3 months	6 months	1 year	2 years	3 years
Hong Kong	–5.4%	–3.0%	–0.4%	3.2%	9.6%
Singapore	–0.9%	3.3%	6.3%	6.1%	5.0%
Korea	–0.3%	1.2%	4.9%	4.3%	
Taiwan	7.5%	11.0%	9.1%	7.9%	

Source: UBS estimates based on data from Governance Metrics International (UBS, 2009).

One qualification needs to be made about the UBS results—while the bank found a link between good governance and share-price performance, unlike CLSA it was not able to establish a link between governance and valuation (UBS, 2009, p.7).

This result is slightly surprising, since many investors believe good governance does indeed lead to higher valuations and lower costs of

capital over the medium to long term, all else being equal in terms of management quality and business performance. And there is anecdotal evidence suggesting that companies with a track record of governance improvements and a prospectus that can be trusted will receive a higher valuation upon IPO. Unfortunately, no detailed study has been done yet on IPO valuations and corporate governance, most likely because it is extremely difficult since valuations are also affected by numerous factors external to any company.

For the sake of completeness, it should also be pointed out that CLSA's analysis of corporate governance in Asia over the past decade has shown that better governed companies tend to outperform in terms of share price during market downturns and periods of economic fragility, when there is a flight to quality, while lower ranked companies tend to do better during booming markets when the appetite of investors for riskier stocks increases. However this general pattern does not (in our view) negate the argument that transparency and accountability are fundamentally good for both capital markets and companies. Any government serious about developing its financial markets must take a long-term view, as must any company which wants to build a trusted brand, and gain strong support from investors and creditors.

Accounting and auditing

A second area of unfinished business—and one closely linked to the quality of corporate disclosure—is the issue of account preparation and audit quality. This is not simply an issue of accounting and auditing standards. As noted earlier, all jurisdictions have converged with international standards set down in the IFRS and International Standards of Auditing (ISA) rule books, or are in the process of doing so (albeit in slightly different ways, and with some exceptions). This is more an issue of how well companies prepare their accounts for audit, and how good a job the auditor does. Even if all Asian markets fully complied with international standards, the problems of preparation and auditing would remain.

A common complaint of the larger auditors around the region is that some of their clients provide incomplete annual or interim accounts for

them to audit. This necessitates a lot of back and forth correspondence after the period end to fill in blanks, and to allow the audit to be completed. PRC companies listed in Hong Kong are often cited in this context, although poor account preparation is clearly an issue in other markets as well. The factors contributing to this problem include a shortage of qualified accountants, under-utilisation of specialised accounting software in account preparation, and inconsistent application of accounting policies by senior management; in addition, accounting is seen as a low-level function within companies.

It seems clear that the inconsistent application of accounting policies in some companies is deliberate—a conclusion that many investors would agree with. Investors point to cases where companies will change their accounting policies (e.g. the recognition of debt or the valuation of assets) from quarter to quarter or from quarter to year-end, in order to manipulate their results in a positive light. While investors can highlight these problems and stay away from investing in companies they do not trust, what is needed in each market is a regulator that has the power to review company accounts and take action if necessary. One regulator that does have such powers is the Securities and Exchange Commission of Thailand.

While auditors may be frustrated with their clients, many investors are frustrated with auditors and the integrity of their audits. The Satyam scandal brought to light some shocking facts about the way in which auditors accepted the bank certificates that were provided by the company, rather than independently verifying this data with the banks themselves (as is required by standard auditing practices). Across the region audit quality has been shown to suffer from a range of pressures and conflicts, including fragmentation within the audit profession (i.e. far too numerous small and under-resourced audit firms in many Asian markets, especially India and Malaysia, theoretically licensed to audit corporate accounts); over-concentration of audits among the large global auditors—demand pressures on the Big 4 + 2[14] is so strong that their staff is stretched, especially during booming markets, and when there are uniform accounting

periods such as in India where most companies close their accounts on 31 March to coincide with tax audit requirements; lack of consistency in audit quality and peer reviews across the national partnerships that make up the global audit networks; and the need to sign off quickly on the accounts of companies applying to do an initial public offering, or simply the pressure of working on numerous IPOs simultaneously.

Following the enactment of the Sarbanes-Oxley Act in the US in 2002, Asian regulators have sought to minimise conflicts within the audit profession by introducing new rules on the mandatory rotation of audit partners, restrictions on non-audit work that auditors may undertake, disclosure of audit and non-audit fees in annual reports, disclosure of qualified audits, and so on. While these efforts appear to have brought about improvements in audit quality and a somewhat more independent audit profession, it seems clear they are not sufficient—not least because booming markets always engender problems, but because auditors are paid by the management teams they are assessing even though in some jurisdictions like India, audit appointments and remuneration are subject to the approval of shareholders in a general meeting.

A complementary (and probably more effective) solution would be the creation of an independent audit regulator that is not controlled or unduly influenced by the profession, and is tasked with carrying out investigations of audit cases and processes, and has the power to apply sanctions on firms and individuals. The role of audit within capital markets is far too important to be left to the vagaries of a conflicted industry body for regulation, or to audit firms for self-regulation.

Board effectiveness

Of all the ideas put forward regarding ways to improve company governance and accountability, none receives as much attention as the notion of board independence. Yet after a decade of board reform, the broad perception is that independent directors and board committees have had only a superficial impact (if at all) on most listed companies. The major faux pas at India's Satyam Computers in 2008–2009 only served to further strengthen this view.

To some degree this is the fault of governments who too quickly brought in mandatory requirements for independent directors and audit committees without (1) spending time persuading companies why these reforms were worth doing and how they would benefit them; (2) ensuring that proper systems of director training were in place for both IPO candidates and existing listed companies; (3) ensuring that the definitions of independent director in their listing rules were truly robust, principles-based, and meaningful, as opposed to artificial, prescriptive, and easily circumvented; and (4) thinking about how to create systems of nomination and election so that the choice of independent directors was not entirely dominated by the controlling shareholders.

It would be unfair however, to lay all the blame at the feet of regulators. Minority investors have generally shown little interest in the selection of *independent directors*, believing for the most part that they are loyal to the controlling shareholder. And most controlling shareholders appear to remain unconvinced that independent directors have much to offer.

Changing these patterns of thinking would be a slow process and may not be possible for those listed companies that are too small and insignificant to have a following. Investors clearly have a role to play in engaging with companies and explaining that, in their view, independent boards do matter and can make a difference. Some of the questions they could ask include the following.

- Board composition and skills: Is the composition of the board appropriate given the strategic direction and needs of the company? Do the directors have a good mix of skills?
- Board committees: Has the board thought carefully about its choice of committees (given the scope and nature of its business), and why it needs them? Or has it merely followed the local code of best practice and automatically set up committees for audit, nomination, and remuneration?
- Independent directors: Have the independent directors been chosen carefully, not merely for their independence, but for

their business acumen and expertise? An independent director who knows a lot about corporate governance but who cannot read the company accounts or contribute to major business decisions is unlikely to be respected within the board or to add much value.

- Director expertise and values: Do all directors understand what is required of a director, and how the role of a director differs from that of a manager? Do they understand enough about local rules and regulations to help the company avoid regulatory missteps (or advise it to seek outside advice)? Do they understand their legal and ethical responsibilities to shareholders and other stakeholders?

Shareholder rights and responsibilities

As the discussion in Section 2 highlighted, shareholder rights is an evolving area in Asia, with different markets at varying stages of development in terms of formal rules and informal practices. At the top of the agenda for institutional investors over the next five years would be the following issues.

- Proxy voting: Earlier release of final AGM agendas and circulars (28 days before meetings); confirmation from companies (or their share registrars) that votes have been received; confirmation from sub-custodian banks or brokers that voting instructions have been executed; ability to undertake split voting and partial voting; full voting by poll in the AGM (i.e. counting of all votes on a one-share, one-vote basis); independent audit of voting results; and publication of detailed voting results on each resolution within one day after the meeting.

- Private placements: Tighter rules on dilutive placements sought—most investors would like to see such non pro-rata share issuances limited to 10% of a company’s total issued capital (or less) in any one year, and discounts of no more than 10% (or less).

- Privatisations/delistings: With the exception of Hong Kong, and to a lesser extent Singapore and Malaysia, protection for minority shareholders where controlling shareholders are trying to delist companies is weak in much of Asia. Regulators need to rethink this issue in consultation with investors and the market.
- Related-party transactions: Most markets have relatively (or extremely) weak controls on related transactions. Again, Hong Kong offers the best model in the region. In addition to mandatory disclosure of transactions above a certain threshold, independent shareholders (i.e. those not interested in the transaction, or are not part of the management or the board) should have the right to approve major transactions in a shareholder meeting. Interested parties and their proxies should be barred from voting in such meetings.

In many parts of the world, notably the US, the UK, and Europe, the global financial crisis has put the spotlight firmly on the role of institutional investors in the economy and what they did (or did not do) to restrain banks and others from taking excessive risks. The popular conclusion is that investors as a group failed to exercise their ownership rights effectively; initiatives such as, for example the UK Stewardship Code, seek to address these problems (FRC, 2010).[15]

While these criticisms are valid and certainly apply to most investment institutions, they tend to ignore or gloss over the efforts of a small number of global pension and investment funds which have been consistently devoting resources to corporate governance stewardship and which accept that they do have responsibilities as well as rights.[16] Many of these institutions are members of ACGA, and also of the International Corporate Governance Network (ICGN), and are signatories or founder signatories of the United Nations Principles of Responsible Investment (UNPRI).[17] Both ICGN and UNPRI lay down specific responsibilities for investors in areas of corporate governance and responsible investing; and

while it is still early days, it is fair to say that these principles are beginning to have an impact on the way these investors behave.

Asking investors to act as responsible stewards is much easier said than done, however. Even among institutions committed to this process there is often a disconnect between their corporate governance work and their investment process. For cultural or philosophical reasons, some institutions are more comfortable engaging with companies (and being seen to do so) than others. And almost all institutions face varying conflicts of interest—the classic one being fund managers who work for different masters, including those who have banks as parent companies, pension funds of listed companies, retail investors in a mutual fund, and so on, and who therefore run the risk of offending one or the other client group if they take too strong a public stand on a particular governance issue

A key element in the discussion of shareholder responsibilities—and one that will likely keep this issue on the agenda—is that if investors do not seek to act responsibly, then the effectiveness of their voting and engagement work, and their efforts to strengthen their own rights and the quality of company governance, will be greatly reduced. In other words, being responsible will give them more credibility with companies and regulators, open more doors, improve the quality of the discussion, and produce greater rewards over the long term.

This ends our discussion of the progress in corporate governance reforms where the major areas of unfinished business in the context of Asia were identified, and policy recommendations were made that would help to reduce investment risks and raise the quality of capital markets around the region.

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Notes

[1] For an elaboration on this point, see Section 2 of ACGA & CLSA Asia-Pacific Markets (2007, pp. 15–29).

[2] In December 2009, the Tokyo Stock Exchange, under direction from the Ministry of Economy, Trade and Industry (METI) and the Financial Services Agency (FSA), introduced a new rule requiring all listed companies to have either one independent director or one independent "statutory auditor". In the Japanese system of corporate governance, the statutory auditor audits a company's compliance with laws and regulations. It is an institution originally derived from the German "supervisory board", although is quite different in operation and considerably more limited in powers. It is also a role distinct from that of the external accounting auditor.

[3] See http://web.ifac.org/about/member-bodies for a full list of the members of IFAC. (Accessed on 18 August, 2010.)

[4] See www.ifiar.org for details on IFIAR. (Accessed on 18 August, 2010.)

[5] Activism in Korea actually started shortly before the 1997 crisis.

[6] Based on ACGA's knowledge of the voting activities of its members, and the volume of resources they increasingly devote to them.

[7] Based on the involvement of ACGA investor members in the Association's recent advocacy and educational activities.

[8] One exception to this was the influence of the People's Solidarity for Participatory Democracy–Participatory Economic Committee (PSPD-PEC) in Korea on some new rules strengthening shareholder rights.

[9] Voting by poll means counting all the shares voted rather than passing resolutions on a simple show of hands, which gives all shareholders present one vote irrespective of the number of shares they own. This legacy of early company law in the nineteenth century disenfranchises investors with higher stakes and those who cannot attend the meeting.

[10] The mixed quality of corporate disclosure in India was covered by ACGA's White Paper on corporate governance in India (January 2010).

[11] CLSA Asia-Pacific Markets is a founding corporate sponsor of ACGA, and the publisher of CG Watch, a regional survey first published in 2000 (on which ACGA has been collaborating since 2003).

[12] Internal data provided to ACGA in February 2010. This had not yet been published at the time of writing of this paper.

[13] The governance data used by UBS comes from Governance Metrics International (GMI), a New York-based corporate governance assessment firm now part-owned by UBS.

[14] The Big 4 plus Grant Thornton and BDO.

[15] See also the Walker Review (2009) on the corporate governance of banks. http://www.hm-treasury.gov.uk/walker_review_information.htm. (Accessed on 18 August, 2010.)

[16] See for example the corporate governance policies published by ACGA investor members, available at http://www.acga-asia.org/content.cfm?SITE_CONTENT_TYPE_ID=40. (Accessed on 18 August, 2010.)

[17] For more on ICGN, see www.icgn.org. For more on the UNPRI, see www.unpri.org. (Accessed on 18 August, 2010.)

5

Anatomy and Limitations of a Legal-Centric Approach to Corporate Governance

K. P. Krishnan, C. K. G. Nair, Anupam Mitra

1. Introduction

Organisations and their interplay with stakeholders and the society at large have been fascinating areas of enquiry for several decades, and the emergence of institutionalism has greatly added to this fascination. Occasional episodes of corporate misadventures and misjudgements provided some more fodder for debate. Following the global financial crisis the need for governance in business organisations has been increasingly emphasised. The question that naturally follows is whether such a mission can be achieved with a legal-centric institutional mechanism, or whether the incentive structure resulting from the social norms has to weave in a higher order motive in business entities. This paper tries to explore this issue drawing on the experiences from some of the recent legal-centric initiatives.

Corporate governance (CG) is a mechanism meant to achieve the objectives of an organisation. But the perspective regarding the objectives varies depending on whether one is a promoter, a manager, or a customer. Undoubtedly, the primary objective from a customer's perspective would be the efficient production and delivery of the product by the organisation. If a car company delivers cars with inefficient brakes and accelerators, or a pharmaceutical company distributes substandard medicines it would result in huge social costs rather than benefits. No other socially responsible

activities can compensate for such a fundamental failure in their core functions. The CG approach that an entity adopts would therefore make a major difference to the society at large.

Definitions of CG vary widely, from the narrow concept of protecting the shareholder's money and interests, to the broader idea of furthering stakeholder interest. In its broadest sense, corporate governance encompasses issues of judicious and sustainable use of the resources of this planet to promote human welfare. This recognises the fact that in achieving economic growth a firm may involuntarily impose environmental and social costs. Corporate governance systems depend on the key principles of transparency, accountability, material disclosures, and equal treatment of all shareholders. However the relative emphasis on these principles depends on whether the ownership structure is concentrated or dispersed. Moreover since governance can be considered to be a "public good" (following the definition proposed in Samuelson (1954)[1], the market on its own may not ensure the optimal level of 'corporate governance'.

In the traditional sense, CG addresses the issue of the principal-agent problem in the context of a limited liability corporation where ownership lies in the hands of shareholders while the company is run by the management which need not necessarily be manned by the owners[2]. The issue then is to align the interests of the principal (the equity holders)[3] with those of the agent (the management). The problem inherent in aligning the interests of the principal with those of the agent is that it is difficult to write a complete contract that can specify desired management action for all contingencies. Moreover, the expectations from CG are now not confined to defining the contractual relationship of owners and managers in the narrow sense but extend to the relationship between different classes of owners, and between them and the management and with the stakeholders and society. It is a complex world of multiple principal-agent problems rendering legal contracting more complex and difficult with attendant imperfections in and incompleteness of such contracts.

Internationally CG is enforced through a mix of primary and secondary legislations— contractual rules which are to be complied with

mandatorily, and norms, codes, and ethical principles which the corporation can adopt voluntarily. The threat of takeover acts as a disciplining device where the market for corporate control is free. While a principle based regulation can partially address the limitations of the incomplete contract, in order to be effective in practice this would demand a very high quality of internal competence among regulators and integrity among firms. The rest of the paper are organised as follows. Section 2 traces the evolution of corporate governance practices in India and abroad. It also explores how a predominantly rule-based approach in India has failed to address the full spectrum of corporate governance issues. Section 3 explores the generic deficiencies of a rule-centred approach, drawing some examples of organisational forms and products. An alternate framework of CG is offered in Section 4.

2. Evolution of corporate governance norms

There have been several instances of spectacular business scams across the world that shook the corporate and financial world— such as the Enron and Worldcom scandals in the US, the Vivendi scandal in Europe, and the Satyam scandal in India. An analysis of the global financial crisis beginning 2007 also indicates the governance failure of corporates including the failure of gatekeepers like credit rating agencies and auditors on several counts. These corporate failures and events have underlined the importance of a proper governance mechanism even in the minimalist sense of ensuring that corporates properly and effectively do what they were established to do, and are accountable in a fair and transparent manner as they were expected to be.

Internationally, there have been a number of initiatives to streamline corporate governance practices. These include the Cadbury Report (1992)[4], the Greenbury Report (1995)[5], the Hampel Report (1998)[6], the Turnbull Report (1999)[7], the Higgs Report (2003)[8], the Smith Report (2003)[9], the Combined Code on Corporate Governance (2008)[10] (all in the UK), and the Sarbanes-Oxley Act (2002) in the US, besides numerous other initiatives.

The Sarbanes-Oxley Act (2002) set new rules and standards relating to financial reporting, internal accounting, personal loans from companies to Directors, whistle blowing etc. for all the U.S. public company boards, management, and public accounting firms, with stringent penalties for violations. It also established a Public Company Accounting Oversight Board (PCAOB) for the regulation and monitoring of US audit and accounting firms. While the Act was a major milestone in the annals of legally-enforced CG norms, the crisis of 2007 came in as a black swan underscoring the limitations of such a legal-centric approach to CG.

CG norms in India have also evolved over the past couple of decades. In December 1995, the Confederation of Indian Industry (CII) set up a task force to design a voluntary code of CG. Between 1998 and 2000, 25 leading companies voluntarily followed the code. In 2000, The Securities and Exchange Board of India (SEBI) set up the Kumar Mangalam Birla Committee whose recommendations were implemented through the now famous Clause 49 of the stock exchange Listing Agreements, setting out mandatory and recommendatory provisions for the governance of listed companies. In early 2000, the government-appointed Sanjiva Reddy Committee issued its report on *Corporate Excellence through Governance*, setting out far reaching recommendations. The Ministry of Corporate Affairs soon after amended the Companies Act 1956 to incorporate specific corporate governance provisions regarding independent directors and audit committees. Since 2001, accounting standards were strengthened and expanded by the Institute of Chartered Accountants of India, and were notified under the Companies Act on the recommendation of the National Advisory Committee on Accounting Standards, to mandate appropriate compliance by companies. The Ministry of Corporate Affairs issued a set of voluntary guidelines for corporate governance in December 2009[11].

Introducing a CG framework in India is a complex task, coping as it must with the problems associated with very large numbers, and the ownership and management structures and operating cultures. A majority of these organisations are family owned; some are family owned but professionally run. Many are public limited but still fewer are listed. As of

March 2009, there were 7,86,774 companies operating in India which were limited by shares. Out of these around 7,04,716 companies were private limited companies and 82,058 companies were public limited. Of the public limited companies, a little less than 5000 were listed on the Bombay Stock Exchange. Many of the large publicly traded companies are in effect controlled by a few minority promoters. Bringing in a legal framework capable of encompassing these different subsets and effectively enforcing a regulatory frame is indeed fraught with complexities and difficulties.

A subset of these companies comprises what could be called *public institutions*, and they need specific mention. These are companies or business entities which are more like public utilities—their structure and conduct affect the society at large irrespective of whether one has a dealing with all of them or not. They are also called systemically important institutions. Banks, financial institutions, insurance companies, stock exchanges, pension funds, clearing corporations, etc. are all examples of public institutions. Many of these institutions may not be even listed entities. As such they do not have the greater disclosure and governance responsibilities embedded in the relevant legal framework. How to enhance their governing standards is another dimension that needs to be addressed.

Corporate governance in India practically revolves around Clause 49 of the Listing Agreement of SEBI, and some provisions in the Companies Act (1956) relating to audit, the constitution of boards of directors, the disqualification of directors, the restriction on the number of directorships etc. Clause 49 contains eight sections dealing with the composition and obligations of boards of directors, the scope of Audit Committees, the remuneration of directors, board procedure, management, shareholders, reports on corporate governance and compliance. The Clause requires that at least one-third of the board should consist of independent directors if the board is headed by a non-executive chairman. If promoters or their relatives are appointed as the non-executive chairman, then independent directors should constitute at least half the board strength, where independence is defined as the lack of any material, pecuniary relationship, or transactions

with the company, other than the director's remuneration, which in the judgement of the Board may affect a director's judgement.[12] It also stipulates that companies should have qualified and independent audit committees with a majority of independent directors, and that the Annual Report should disclose details of the remuneration of directors, and should contain all management discussions and analyses. Additionally, Annual Reports should contain a separate section on corporate governance detailing compliance with the mandatory and non-mandatory requirements proposed by SEBI.

How independent the independent directors can be in practice is a different matter, given that they could be handpicked by the promoters. The fact that the promoters themselves select and appoint independent directors involves a conflict of interest. This mode of selection creates a sense of obligation and loyalty to the promoters which can interfere with the independent, frank and unbiased expression of opinion which would be necessary to safeguard the interests of the other shareholders. Directors appointed to the boards by investing or lending institutions are expected to be more probing and scrutinising, though their role in the Indian context has remained inadequate.[13] It is often suggested that in order to make independent directors truly independent, it is necessary for the government or the regulatory authority itself to appoint them. Today there is no mechanism by which an investor can access the views or expertise of an independent director; there is no platform from which an independent director can talk to a company's shareholders about his/her participation in board decisions that affect their interest. Even when a director wishes to resign, he/she has to depend on the company. He/she cannot on his/her own inform the authorities or the shareholders that he/she has resigned and would continue to be responsible to the shareholders in case of any delay by the company in notifying the authorities. Moreover shareholders are often unaware of whether (and why) a particular director or directors voted in favour of or against a move. If the summaries of board meetings, or more importantly the discussions that took place before an important decision is taken, are disclosed shareholders would be better informed.

3. Deficiencies of a legal-centric approach

The basic challenge of effective CG stems from the fact that it is difficult to measure human nature, motive, and behaviour and to create legislations that can control, modify, and regulate them. This remains true irrespective of whether the regulatory approach is principle-based or rule-based—both are more often than not observed in letter rather than in spirit as was demonstrated during the recent financial crisis. The emphasis on CG reforms has been on the functioning of the board of directors, and the various committees appointed by the board. Structural reforms in CG have centred on having a higher proportion of independent directors, on prescribing diverse sets of skills and expertise as the eligibility conditions to be a director, mandating regular attendance, ensuring the financial literacy of audit committee members, and setting up special purpose committees for key functions like executive compensation, risk management etc.

While efforts in the direction of making the boards more professional and independent are laudable, the outcome of such initiatives has been limited. Satyam Computer Services Limited had inducted highly reputed professionals into its board of directors. Few corporations could boast of more financial competencies and experience than what was possessed by that group of people. Yet the reputation of the company was badly tarnished when its founding chairman confessed to the falsification of accounts and other financial records of the company. Interestingly in Satyam the promoters did not even have a controlling stake.

While we can mandate attendance, can we legislate a director's involvement and quality of participation in the management of the company? Can codes and statutes prevent him from being a passive member of the board? It is possible that despite having an ideal composition, the board could be reduced to merely approving the decisions already made by select members of the board and the top management.

Similarly the financial reporting process and the quality of accounting can be streamlined and standardised to a certain extent for tangible assets, but the valuing of major intangible assets like human resources, brand,

customer franchise, organisational structure, intellectual capital, goodwill, etc. would still need to be done by the company in good faith. For instance, in order to measure the monetary value of human resources, it is generally accepted that the present value of the future earnings attributable to human resources needs to be considered. However a judgement has to be made on the appropriate discount rate among other factors. Again while calculating depreciation, an estimate of useful life needs to be made, which is more a matter of policy and judgement than a technical estimate.

The valuation of intangible assets plays an important role in mergers, acquisitions, and joint ventures. It gained importance with the emergence of knowledge based companies whose market capitalisations were a large multiple of their tangible asset values. Even the valuation of tangible assets can be challenging. Consider for instance a complex derivative for which there is very little liquidity in the market, and so the accountant cannot mark to market and is left with the option of marking to one of the various models available, each with its own sets of assumptions. Even with stringent regulations it is difficult to judge the fairness of all the related party transactions executed by the company. The Board through its audit committee is responsible for ensuring that the information disclosed is consistent, comparable, and complete as per law. A widely observed tendency is to observe this requirement by burdening shareholders/investors with a huge quantity of poor quality information that is incomprehensible and does not aid in assessing the worth of a company.

The subject of handling non-public, price sensitive information goes well beyond the scope of existing laws, and there are inherent limitations in enforcing many aspects of ethical conduct of market practices (for instance, to tackle insider trading[14] and front running[15]) through legislative or regulatory means. Ethical market behaviour comes from education and the recognition of the need for control and avoidance of conflicts of interest. Firms must appreciate that by following good governance practices the corporate sector would be in a better position to enhance not only the economic value of the enterprise but also the value for every stakeholder who has contributed to the success of the enterprise. Sound and

efficient CG practices are the foundation for stimulating the performance of companies, maximising operational efficiency, achieving sustained productivity as well as ensuring protection of shareholders' interests. In particular, the role of professional analysts who assist investors in making investment decisions is very critical. Biases/conflicts emanating from personal affiliations and cross-holding by group companies need to be avoided. Since such decisions also involve subjective and judgemental issues, it is difficult to codify appropriate and best practices legally.

CG is manifested in a variety of conducts and practices like how sincerely (i.e. with what degree of factual accuracy) a product is advertised, how information is disseminated, whether disclosures are properly made etc. Often it is found that firms observe regulations in letter but not in spirit—there are hidden costs, expenses and risk factors which are conveniently glossed over to emphasise only the returns thereby conveying a wrong impression. Advertisements are often guilty of errors of omission (non disclosure or improper disclosure) and commission (making fictitious claims, selective disclosures highlighting performance in good times, or understating risks and overstating benefits). Various marketing gimmicks including mislabelling of products are employed, confusing the investor (Basu, 2006). Firms often try to push products that are unsuitable for the consumer but fetch high commission for the seller.

Financial innovation has been at times aimed at avoiding taxes, bypassing regulations, concealing leverage, confusing investors and reducing transparency. Das (2006) elaborates how such innovations were engineered to thwart competition and prevent clients from unbundling the product. Opaque, complex structured products became a lucrative source of commissions and rent. In the world of derivatives there are issues related to applying the appropriate valuation, etc. which are to some extent judgemental. Further, these are off balance sheet items and the risks posed by such instruments may not be apparent at when entering into a transaction. Credit Default Swap (CDS) is one such derivative that wreaked havoc during the recent financial crisis. CDS is in essence not a derivative product; it is basically an insurance product masquerading as a

derivative to bypass the legal requirement of an insurance licence to issue an insurance product. The problem of treating CDS as an insurance product is that the insurer has to prove *real loss* in order to claim the insurance. Treating CDS as an insurance (which it actually is) means that speculators cannot play in this market. Only hedgers and those entities who hold a particular bond can buy CDS. Not treating it as an insurance resulted in massive speculative activity so much so that the CDS claims exceeded the total amount of outstanding bonds of the reference entity. The unwinding of such highly leveraged positions exacerbated the financial crisis.

The Collateralised Debt Obligations (CDO) market also has a very opaque structure. This derivative involves tranching—partitioning of securities into various categories, depending on their risk and return. The end investor holding the CDOs is not fully aware of the inherent risks in such instruments. The Special Purpose Vehicle (SPV) created to facilitate the structuring of this product is an unregulated entity even as it indulges in shadow banking.

Private Equity (PE) funds are another group of companies that have serious corporate governance issues regarding their structure and mode of operation. The basic problem with PE funds starts with the fact that they are not a clearly defined entity, leading to difficulties in tethering them to CG rules and codes. The role of Credit Rating Agencies (CRAs) has come under the scanner in the wake of the financial crisis beginning 2007. While they were supposed to be professionally rating the debt and derivative instruments, they became party to the creation of highly rated complex instruments. CRAs and auditors are performing gate keeping role in the corporate/ financial sectors. As such they becoming partners in creating new instruments and rating them was in many ways a larger malady of CG framework.

4. An alternative framework of corporate governance

Given the limitations outlined in Section 3, there is a need to go beyond a legal-centric approach to CG if the larger societal aspirations are to be realised. Such an alternative approach would need a judicious mixture

of rule-based regulation and self-enforced codes. Ayers and Braithwaite (1992) assert that regulatory responsiveness should take into account the diversity in industry structure, levels of competitiveness, etc. and involve community participation; their concept of “escalating strategy” could be applied to CG as well. But, ironic as it may sound, there is the need for a sound legal-institutional structure to ensure that the norms and rules are practiced by the players. A legally empowered institutional structure would ensure this, while at the same time allowing the regulators to watch from the boundaries rather than being too inquisitive micro-managers.

The financial crisis has clearly shown that a pure Self Regulatory Organisation (SRO) model of self-enforcement is incapable of resolving issues related to conflicts of interest among the various members, since it usually degenerates into a business group lobby. The regulatory regime for corporate governance should be sensitive to the level of maturity attained by the market. An ethics enhanced incentive structure needs to be formulated. For an ideal market with a high level of financial literacy, a pyramidal structure for enforcing corporate governance can be considered, where the nature of regulation at each level has to be compatible with the maturity of the players, the number of players and the systemic risk they potentially pose.

One way to broad-base corporate governance norms or promote corporate democracy would be to increase public shareholding in listed companies. To be effective, public holding should also address issues of cross holding, pyramid ownership structures, and other mechanisms of control which have been extensively discussed in the context of holding company structures. It should also deal with the issue of *acting in concert* getting camouflaged, which is why not only the issue of threshold level of public holding is important, but also the definition of the terms public or promoter or both. Only entities which are directly or indirectly not linked to the promoters should become part of the *public*. Such entities are FIIs, Banks, Insurance Companies, Pension and Provident Funds, Mutual Funds, individuals/retailers, etc. On the other hand any entity having a stake directly or indirectly before the IPO of a company should be treated as a promoter.

Here again, while a threshold percentage of public share holding is important, the spirit behind enhancing corporate democracy is much more critical to CG. This underscores the norms vs. rules debate further. What is required is a reasonable share of public holding to ensure adequate liquidity and efficient price discovery, as well as respect for minority shareholders. In short, CG norms need to get woven into the structure of the organisations as well as into their conduct and practices. In this sense CG can be discussed in a structure-conduct-performance framework.

While attempting to bring forth the importance of a normative approach to CG, the endeavour of this paper is not to position it as a rule-centric vs. norm-centric issue. The framework has to be clear enough for an understanding of the boundaries of the rules and regulations on the one hand and those of the norms and values on the other. This framework should also decide the boundaries for the regulators involved. In a principle-based formulation, the interpretation of the principles is very important. For regulations, norms, codes, and statutes to be effective, proper and clear empowerment of the regulators administering them is essential. This would require greater awareness and financial literacy on the part of both the regulating and the regulated entities.

In conclusion, given the norm and value embedded nature of CG for an effective framework governing the code of conduct of business entities in defining their responsibilities towards the larger stakeholders, a mechanism of escalating strategy needs to be adopted, involving as it should public participation, self-enforced regulation, enforced regulation, command and control. This is the framework of the Braithwaite pyramid of escalating strategy wherein public interest, self-regulation, mandated self-regulation and a system of controls co-exist. For the success of such a system however, a sound legal framework is required. This needs to be reinforced with the first principles of norms and values. Only such a framework could liberate the mutuality of corporate action for the collective welfare of the society who is the ultimate stakeholder because no corporation or business entity exists in a vacuum. However, given the fact that visibility in a crowded environment is limited for any entity, the

supporting legal framework and the embedded code and values should provide heightened vision to them for assimilating the higher order objectives of their own existence.

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Notes

[1] Samuelson (1954) defines public goods as those whose consumption is non rivalrous and non excludable. According to the theory of public finance, goods with such attributes give rise to externalities affecting people not directly involved in the transaction. As a result there is either over production (in the case of negative externality) or under production (in the case of goods with positive externality) of such goods.

[2] While in the Anglo American model of corporate governance, the agency problem lies in making the management run the firm in the interests of shareholders, in the Indian context the primary agency problem has been between promoters (often with minority holdings) and minority shareholders. Such promoters are able to extend their sway over the company by taking advantage of the dispersed nature of shareholding, use of cross holding, and pyramidal corporate structures (Mukherjee, 2004).

[3] Although debt holders are governed by mutual covenants and therefore are not owners/ principals in the conventional sense, they do have a direct stake in the performance of the company and hence may be deemed to have an ownership stance in an extended sense.

[4] The Cadbury Report (1992) focused attention on the board of directors' accounting and auditing functions, and emphasised the importance of institutional investors as the most influential group of shareholders. It also mandated that listed UK companies establish audit committees composed of non executive directors.

[5] The Greenbury Report (1995) focused on identifying good practices in determining the remuneration of directors. Among other things, it recommended that the remuneration committee should consist exclusively of non executive directors. It also recommended full disclosure of pay and perks of directors in the Annual Report.

[6] The Hampel Report (1998) emphasised the importance of maintaining principles based voluntary approach to corporate governance rather than following a prescriptive "box ticking" approach.

[7] The Turnbull Report (1999) aimed to provide companies with general guidance on how to develop and maintain their internal control systems.

[8] The Higgs Report (2003) dealt specifically with the role and effectiveness of non executive directors. The report suggested establishing strong links between non executive directors and companies' principal shareholders. In particular the report recommended that one non executive director assume chief responsibility of shareholder interest.

[9] The Smith Report (2003) focused on the relationship between the external auditor and the companies they audit, as well as the role and responsibilities of companies' audit committees.

[10] The Combined Code on Corporate Governance (2008) is not a rigid set of codes and rules. Rather it recognises that non compliance may be justified in particular circumstances if good governance can be achieved by other means. The Code follows a "comply or explain" approach.

[11] *Corporate Governance*: *Voluntary Guidelines 2009* brought out by the Ministry of Corporate Affairs has been proposed for voluntary adoption by the corporate sector, and takes into account the recommendations of the Task Force set up by CII under the chairmanship of Naresh Chandra in February 2009. The guidelines inter alia propose a clear demarcation of the roles and responsibilities of the chairman of the board and those of the managing director/ CEO to improve the balance of power, and to prevent the vesting of unfettered decision making power with a single individual. It also proposes a maximum tenure of six years for an individual to remain as an independent director with a cooling period of three years, and also restricts the number of companies in which an

individual may serve as an independent director to seven. According to the guidelines an independent director should not be paid stock options or profit-based commissions as that may compromise his independence. An interesting recommendation is to attach an "impact analysis on minority shareholders" for every agenda item in the board meeting. Further the independent directors should discuss such impact analysis and record their observations. The guidelines propose that audit partners should be rotated once every three years, while the audit firm should be rotated once every five years with a cooling period of three years. The companies are also requested to provide adequate safeguards against the victimisation of employees who avail of the whistle blowing mechanism, and to allow direct access to the chairperson of the Audit Committee in exceptional cases.

[12] Mukherjee (2004) is sceptical as to whether a simple majority of outside directors is an indication of board independence given the influence that promoters yield in the selection of outside board members.

[13] Ghosh (2005) discusses that in the US and the UK, there is an active market for corporate control to discipline managers, while in Japan and Germany, the main bank that finances the corporation acts as an external disciplining entity.

[14] Insider trading refers to trading that takes advantage of non-public information which is often available to an insider of the organisation. It refers to an act of buying, selling, or dealing in securities by any person while in possession of unpublished price sensitive information relating to such securities.

[15] Front running is an activity in which a trader takes a position of unfair advantage in advance of a large buy or sell order that the trader knows will move the price of that equity in a predictable fashion. Direct market access—which is a facility allowing clients direct access to the exchange trading system through the brokers' infrastructure without manual intervention by the broker—can tackle this problem to some extent.

6

Enforcement of Corporate Governance in India: Steps Forward

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1. Introduction

The debates related to corporate governance in India have only increased in frequency and importance following the revelation of the Satyam fraud in January 2009 (Kripalani, 2009; Sanyal & Tiwari, 2009; Sukumar, 2009). The Confederation of Indian Industry (CII) and the Institute of Company Secretaries of India (ICSI) have come out with recommendations meant to enhance governance in India and to prevent future frauds (CII Report, 2009; ICSI Report, 2009). Although these recommendations address many areas, one concern that is common to most of these reports is enforcement (KPMG Report, 2008; CII Report, 2009; ICSI Report, 2009). It is generally accepted that consistent and effective enforcement is vital for enhancing governance, encouraging stock market development, and improving firm value (Coffee, 2007; Daines & Jones, 2007; Dharmapala & Khanna, 2010; Eluvangal, 2009; Jackson & Roe, 2009; Khanna, 2010b). In some countries, enforcement is often conducted through a web of government enforcement (e.g. criminal sanctions), private enforcement (e.g. civil suits filed by shareholders), and liability

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against third parties (like accountants for instance). In India however the overwhelming majority of corporate governance enforcement rests with the various arms of the government, with private civil litigation playing effectively no role. Further the general perception is that this government enforcement is insufficient, inefficient, and slow, especially in light of the delays in the Indian legal system (Debroy & Singh, 2009; Khanna, 2010a; National Mission for Delivery of Justice and Legal Reform, 2009). This paper examines corporate governance enforcement in India and explores what kinds of enforcement reforms might be beneficial taking into consideration both the ownership structure of most Indian firms and India's institutional considerations in the legal and judicial sphere.

The primary recommendations made in this paper are that (1) government enforcement can be improved by developing early warning systems (to identify potential governance problems) and by reforming certain parts of the criminal law; (2) building some measure of private enforcement (of which there is effectively none in India) may be beneficial; and (3) enforcement in India should focus on the governance concerns most likely to be prevalent in Indian firms (a majority of which are controlled firms).

This paper begins by examining potential changes to government enforcement. Recent studies have found that government enforcement of corporate and securities law is crucial to various measures of stock market development (Coffee, 2007; Daines & Jones, 2007; Jackson & Roe, 2009). The Securities and Exchange Board of India (SEBI) is the primary regulator of the stock markets in India. It has a broad mandate and has been engaged in an increasing number of enforcement activities (SEBI Annual Report, 2008–09). However it has not really been tested in terms of policing corporate fraud like Satyam, and given SEBI's workload and budgetary considerations it is probably time to consider what additional steps can be taken to make government enforcement more effective. Given the delays in the Indian judicial system it would appear that steps to reduce the need to rely on courts might also be desirable. For instance providing early warning signals to regulators and investors to enable them to initiate

some kind of action might prove beneficial. In addition, utilising criminal laws in a targeted manner could prove desirable because it would have a considerable deterrent effect, and would send out messages (or signals) to society about what kinds of conduct are acceptable (Khanna, 1996; Packer, 1968; Shavell, 1985). However criminal law enforcement can be misused and so it is important to address ways in which to constrain such enforcement to ensure that it narrowly targets only the truly culpable, and to reduce the scope for potential corruption and harassment (e.g. by reducing the ability of authorities to arrest directors in a hurry without sufficient proof, by ensuring serious sanctions for filing false reports, etc.) (Hylton & Khanna, 2007; Khanna, 2010a; Parker, 1993).

In addition to changes in government enforcement, building measures of private enforcement would provide some key advantages. In particular the possibility of private parties recovering losses suffered due to fraud is important to encourage private parties to provide enforcement relevant information to the authorities (Landes & Posner, 1975), and to encourage investment and enhance stock market liquidity (Khanna, 2010b). However providing shareholders in India the right to sue would necessitate their involvement with the Indian judicial system which is not an attractive alternative given the delays involved in this route. Another alternative that could be considered is the addition of a provision in the Stock Exchange Listing Agreement (SELA) which would say (in effect) that all alleged violations of the law that lead to losses to shareholders are to be addressed in binding arbitral proceedings unless specifically agreed to otherwise. Arbitration would then become the default course of action for shareholders unless both the firm and the shareholders explicitly agree to opt out of arbitration. As a supplement to arbitration, one might consider providing small rewards to non-shareholder parties who provide enforcement relevant information to the authorities.

Finally when it comes to the matter of enforcement there needs to be some degree of discretion in deciding what enforcement actions to bring, who to pursue for liability and so forth, regardless of what enforcement system is in place. One example of guiding enforcement discretion is found

in the United States where government authorities often provide guidance on how their enforcement discretion might be used (Thomson Memo, 2003). The key would be to make the application of discretion transparent and rational. In the context of corporate and securities laws it would be crucial to focus on the kinds of violations that would be of concern to India given the controlled ownership structure of the majority of Indian firms. Thus spending enforcement resources on monitoring corporate control contests would appear to be unnecessary (in the Indian context) as most Indian firms do not have control that is contestable, and spending resources on calculating or disclosing executive compensation need not be a primary goal because managerial expropriation of firm value through compensation schemes is a concern generally associated with dispersely held firms not controlled ones (Bebchuk & Hamdani, 2009; Khanna, 2009a). However resources focused on monitoring *tunnelling* activities and related-party transactions could produce much greater marginal benefits, as could resources focused on the selection of independent directors (Bertrand et al., 2002). Of course if the ownership structure of Indian firms changes over time then so would the enforcement focus, but this is a *non sequitur*.

We provide a broad overview of the enforcement structure for corporate and securities laws in India in Section 2. Although government enforcement represents the overwhelming majority of enforcement activity in India, it is informative to examine how the enforcement is structured and who the authorities empowered to act are. Section 3 explores some of the theoretical issues related to enforcement that are relevant to the current inquiry. Section 4 discusses how the issues raised in the preceding sections are affected by the institutional and ownership contexts in India, and proposes reforms to the enforcement system in India. We conclude the discussion in Section 5.

2. Enforcement structure for corporate and securities laws in India

Law and enforcement are important for the growth of stock markets for a number of reasons. Investors tend to invest in firms and jurisdictions

where they perceive attractive returns and sufficient protections for their investments that make them feel secure enough to invest their capital in firms located far away from them (Daines & Jones, 2007; Jackson & Roe, 2009; Khanna, 2010b; La Porta et al., 2006). This security could be obtained in some measure through private ordering—reputational mechanisms, reliable intermediaries, etc.—as well as through the law (Coffee, 2001). Thus one way in which the law could play an important role is by providing investors with some protections against undesirable outcomes. Of course, some firms and executives may comply with the law voluntarily, but some might not. It is in the latter situation that the necessity and relevance of enforcement becomes apparent. In particular, enforcement can provide signals about government attitudes toward acceptable governance standards and what areas are likely to witness the bulk of enforcement activity (Milhaupt & Pistor, 2008), assurances to investors about the credibility of firm disclosures by imposing sanctions on misleading or inaccurate disclosures (Daines & Jones, 2007), assurances to investors about the credibility of the measures meant to protect investors' property rights against expropriation by punishing such expropriation (La Porta et al., 2006), and assurances to investors that they can have their grievances addressed in some efficacious manner (Coffee, 2007; Jackson & Roe, 2009; Khanna 2010b; Roe & Siegel, 2009).[1] All of these effects would encourage smaller investors to invest in firms, leading to better stock market development.[2]

In this context it becomes important to consider the various kinds of enforcement methods that might be used to provide investors with the protections they desire.[3] At a conceptual level there are at least two possibilities. First, there is enforcement by the government via civil penalties or criminal sanctions (i.e. public enforcement). And then there is enforcement by the victims of wrongdoing (or private parties) to recover damages or obtain an injunction by civil suits (i.e. private enforcement).

Public enforcement in India

Corporate and securities laws in India are enforced through the many different arms of the government. We provide an overview of the four primary arms of the government that enforce the laws in this area.

Securities and Exchange Board of India

SEBI enforces matters arising under the Securities & Contracts (Regulation) Act 1956 (SCRA, 1956) and the Securities & Exchange Board of India Act 1992 (SEBI Act, 1992), as well as the regulations and rules promulgated under these Acts.[4] SEBI's decisions can generally be appealed in the first instance to the Securities Appellate Tribunal (SAT), the High Court, and then potentially to the Supreme Court of India.[5] Both the SCRA (1956) and the SEBI Act (1992) contain provisions and regulations that are relevant to corporate governance. Perhaps the most important is Section 23E of the SCRA (1956) which states that a violation of the Stock Exchange Listing Agreement (SELA) can result in severe financial and criminal penalties for the directors and the firms involved. The SELA contains Clause 49 which is the watershed corporate governance provision in India. Violations of Clause 49 can be enforced by SEBI under Section 23E of the SCRA.[6] The crucial matter is then whether these provisions have been enforced.

Although it is well known that a number of firms are not complying with the provisions of Clause 49 (Balasubramaniam et al., 2010), the first (and to date, the only) time SEBI initiated investigation proceedings was in September 2007 (SEBI Press Release, 2007). This was more than seven years after the initial enactment of Clause 49, and nearly two years after all firms which were subject to Clause 49 were to have complied with its provisions. The proceedings were primarily initiated against firms owned by the Indian government, and to date no sanctions have been imposed.[7]

In addition to Clause 49, there are a number of other SEBI regulations that could address governance issues, such as insider trading, and other forms of unfair trading practices;[8] the failure of a firm to address investor grievances sent to the firm by SEBI or a stock exchange;[9] and violations of certain provisions in the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, as amended in 2010 ("Takeover Code").[10]

SEBI has brought enforcement actions under some of these rules, but often the issues are not at the core of governance concerns, but are at

the periphery (SEBI Annual Report, 2008–09). However the presence of active SEBI enforcement in primarily noncore governance areas suggests that SEBI could be a useful source of enforcement and could provide credible deterrence related to governance issues if it became more active in enforcement.

Ministry of Company Affairs

Although SEBI is the primary enforcement agency for violations of securities laws, the primary agency for the investigation of company laws is the Ministry of Company Affairs (Ministry of Company Affairs Annual Report, 2005). The ministry acts mainly through its investigations divisions, serious fraud investigation office (SFIO), regional directors, and registrars of companies. The investigative authority is broad, but the provisions for which cases can be brought are limited to those mentioned in this paper, especially the criminal provisions.

Company Law Board

Another important enforcement arm of the government is the Company Law Board (CLB) (which is supposed to be replaced by the National Company Law Tribunal (NCLT)).[11] The governance related matters which the CLB primarily deals with are claims of oppression and mismanagement under Sections 397 to 399 of the Indian Companies Act 1956 (ICA, 1956). These sections are not often seen as important remedies because the most common remedy available is an injunction, and also because the CLB has the power to insulate directors from liability under Section 633 of the ICA (1956) (Ramaiya, 2006). Moreover the CLB has not often been very fast, and the delays would reduce any potential gain to shareholders from such actions.

Reserve Bank of India

The Reserve Bank of India (RBI) can regulate certain matters under the Foreign Exchange Management Act 2000 (FEMA, 2000) that can have an impact on governance.[12] As these matters are generally not considered as core governance concerns, we will not discuss the RBI's enforcement role in any great detail.[13]

Criminal actions under the Indian Penal Code

The Indian Penal Code (IPC) provides a number of provisions under which governance related matters can be addressed. These include criminal breach of trust (section 406) and cheating (section 420).[14] Although these provisions do not target core governance concerns, they are sometimes used to address these concerns (Khanna & Mathew, 2010). However conviction rates are not terribly high (a concern found in many areas of the IPC and related criminal provisions) and hence the deterrent effect of these provisions is likely to be attenuated (Debroy & Singh, 2009; Khanna 2010a). Nonetheless the power to arrest is ubiquitous even if convictions are not. This particular equilibrium (easy arrest and difficult convictions) is troubling on multiple levels and is a matter that needs to be addressed before criminal laws can be used effectively in this area (Khanna 2010a; Khanna & Mathew 2010).

Private enforcement: Common Law

There is essentially no private enforcement existent in India for corporate governance related matters.[15] One of the critical impediments shareholders face are provisions in the relevant Securities Laws that prohibit civil courts in India from entertaining suits on a matter over which SEBI is empowered to act.[16] Nonetheless assuming that the securities laws did not contain such prohibitions, we discuss in the next few paragraphs some of the potential actions where private enforcement could arise to highlight how these potential actions are essentially not available in India for governance related matters.

Private enforcement in India could (in theory) arise through potential application of the Common Law, the possibility of a statutory fraud claim under Section 17 of the Indian Contract Act 1872, and potential claims for misrepresentation in a prospectus under Section 62 of the ICA (1956). In each of these areas the chances for shareholder recovery are essentially nil and the delays in the Indian judicial system would only serve to minimise any potential gains.

Under the Common Law one possible claim would be the tort of Deceit. However this has a number of requirements that make its availability rather limited (Ramaiya, 2006). These include (1) the existence of a fraudulent misrepresentation; (2) the requirement that the representation relates to a material fact; and (3) the stipulation that the plaintiff received the shares directly from the company by allotment.

The third requirement essentially means that purchasers in the secondary market can make no claims unless the misrepresentation was made to them directly (e.g. face to face) (Ramaiya, 2006). In the United States this is referred to as the individual reliance requirement, which makes recovery extremely difficult for most shareholders who would rarely be able to show they explicitly relied upon the misrepresentation in a face-to-face transaction (Loss et al., 2010). Consequently in the United States the *fraud on the market* presumption helps to alleviate concerns with proving individual reliance by presuming that share prices reflected the misrepresentation and that individual investors relied on those share prices in engaging in their transactions (Choi & Pritchard, 2008). However, India has not yet adopted this presumption for the tort of Deceit. In addition judicial delays would further trivialise any (highly unlikely) recovery that might be available.[17]

Similarly the statutory remedy for fraud under the Indian Contract Act 1872 comes with a number of requirements that makes its usefulness for governance issues rather limited. There is a requirement that the fraud be engaged in by a party to the contract (or its agent) which is rarely the case for secondary market purchasers (Singh, 2004).[18] Further, the individual reliance requirement is also a sizeable impediment (Singh, 2004).[19]

Overall, corporate and securities law enforcement in India is public enforcement with essentially no private enforcement, which is further hampered by the delays in the Indian judicial system. Moreover public enforcement has shown a tendency to focus on issues related to market structure and process (e.g. settlement days) rather than more standard corporate governance concerns.[20] The limited nature of enforcement in this area would make it more difficult for dispersely held firms to develop in India because with weak protections, investors may need to rely on setting

up control blocks and other methods to secure their interests (Coffee, 2001; Roe, 1994).

We find that many of the surveys of corporate practices in India note enforcement as one (often, the most) critical concern for corporate governance in India. These studies suggest that the respondents felt that the penalties were too low, and that there was weak oversight and monitoring. The same studies also find that many respondents would prefer to see greater protection of minority shareholders, along with more evaluations of whether the board is performing well, granting independent directors more power, and conducting more board sessions without the management present (CII Report, 2009; ICSI Report, 2009; KPMG Report, 2008).

This overview of the enforcement structure of corporate and securities laws in India was meant to provide a sense of the basic approach in India which is public enforcement with essentially no private enforcement. The question is whether this is desirable. To explore this question, Section 3 describes the theory on optimal enforcement, and in Section 4 we consider how the insights from Section 3 may apply to the Indian context.

3. Enforcement theory: An overview

In exploring optimal enforcement theory we focus on those issues that appear to have the greatest relevance to India, namely the optimal balance between public and private enforcement, and the optimal mix of sanctions (monetary and non-monetary). Table 1 provides an overview of the broadest categories of enforcement options. The rest of this Section summarises the vast literature on the economics of enforcement and what factors are relevant in making a choice from among the enforcement options.

Table 1: Enforcement options

Issues	Options
Identity of enforcing entity	• Government • Private party
Type of sanction	• Monetary • Non-monetary • Preventive ex ante

Public enforcement, or private enforcement, or a combination of both?

There are at least two rationales for having private enforcement, one related to enhancing enforcement, and the other to potentially enhancing stock market development by deepening liquidity. In terms of enforcement rationales, the key advantage of private enforcement is that the victims of wrongdoing probably possess information on the wrongdoing that public enforcement agents cannot access as easily as the victims (Landes & Posner, 1975). For example, victims often possess knowledge about who injured them and how. Such information might be difficult or expensive for public authorities to access. Private suits for damages provide incentives for victims to come forward with their information, increasing the chances that the wrongdoer will be sanctioned and thereby increasing deterrence.[21]

Access to the information that private parties have can be obtained in multiple ways. Private parties could be allowed to sue to recover damages. Such a method requires that private parties approach the courts for damage recovery, and subjects them to the cost and delay of civil litigation. One alternative to private litigation is to provide private parties with rewards (e.g. bounties) when they provide enforcement relevant information to public enforcement agents (Polinsky, 1980). This method allows for information to be provided, but does raise issues regarding the amount of the bounty, how many people are entitled to it, and how to deal with false information (Fitzner et al., 2007; Rich, 2008).[22] Rewards work particularly well when the information is provided *before* the public enforcer would have discovered it anyway, and when there are not many private parties all expending resources to be the first to provide that information to public enforcement. In other words, we may not want to create an incentive for people to spend great amounts of time and resources ferreting out such information if it can be obtained in simpler, less expensive ways (Kaplow & Shavell, 1994; Polinsky, 1980).

Private enforcement might also be desirable because it provides compensation to victims of governance wrongdoing (assuming no insurance

is available to victims), and this would help in stock market development by attracting more investors to invest in Indian firms. This is in essence an argument that provisions for compensation for losses suffered should increase the liquidity of the markets (Choi & Pritchard, 2008; Khanna, 2010b). This argument appears to have some force—if investors think that they cannot recover losses suffered due to fraud (or would have difficulty in doing so, or would have to wait a long time to do so), then one would expect investors to be reluctant to invest. This however oversimplifies the concern.

The risk of fraud is another type of risk that investors face which might (in theory) be addressed much the same way as some other risks are handled—for instance, through diversification. However diversification cannot easily reduce any systemic risk associated with fraud. If a particular market is perceived to be rife with fraud then shareholders might simply avoid investing in that market which would hamper stock market development (Akerlof, 1970; Choi & Pritchard, 2008). Further if diversification is expensive then at the margin that too would hamper stock market development by reducing liquidity.[23]

Thus both for enforcement reasons and liquidity reasons it would be desirable to provide for some kind of private enforcement. Whether this takes the form of full private civil litigation, something moderately less than that, or rewards will be discussed in detail in Section 4.

Setting Sanctions

Another critical enforcement matter is related to what kinds of sanctions should be used and when. There has been considerable research on this topic. The discussion begins with Becker's (1968) seminal article which starts with the notion that people consider the expected sanctions (and gains) when acting, not just the nominal sanction. An expected sanction is the actual sanction multiplied by the likelihood of its imposition. For example, if the penalty for insider trading is $100,000 and the likelihood of its imposition is 50% then the expected penalty is $50,000. To deter someone from engaging in a harmful activity the expected sanction needs to be set equal to or slightly higher than the harm caused. Thus $h = f x p$,

where h = harm; f = fine (or sanction); and p = probability of imposition of that sanction. The expected sanction is then $f \times p$.

Thus, if the harm is $1 million and the likelihood of imposition is 20% then the fine (or sanction) needs to be set at $5 million to generate an expected sanction of $1 million. If the actual sanction is set at less than $5 million then the potential wrongdoer stands to gain by engaging in the harmful activity. The probability of imposition is sensitive to enforcement expenditures—the more the amount spent on enforcement, the higher the probability of imposing a sanction. Thus we can obtain the same expected sanction by increasing enforcement expenditure and reducing the magnitude of the actual sanction, or by decreasing enforcement expenditure and increasing the magnitude of the actual sanction. For monetary sanctions the general idea is that increasing the sanction does not increase social costs, but increasing enforcement expenditures does.[24] Thus the preference is to reduce enforcement expenditures and increase the actual sanction.

However at some point, an upper limit will be reached on the actual monetary sanction that can be imposed (e.g. the potential wrongdoer's wealth or some threshold dictated by political, social or moral considerations). In order to achieve more deterrence it may be necessary to either increase enforcement expenditure or use non-monetary sanctions (e.g. imprisonment). Non-monetary sanctions do have social costs (e.g. costs of maintaining prisons, denying prisoners their liberty) that need to be balanced against the benefits of increased deterrence and compared to the net gains of increased enforcement expenditure (Shavell, 1985). Thus where monetary sanctions cannot be increased any further we need to use non-monetary sanctions or increase enforcement or a mix of both.

The need for non-monetary sanctions increases with the harm caused by the wrongdoing because it is then more likely that monetary sanctions will not be enough to cover the losses caused. Thus, the general sense is that non-monetary sanctions should be reserved for those activities that are more harmful.[25]

However it is possible that the harm caused by certain activities is so large that even the presence of non-monetary sanctions with increased enforcement may not result in the desired level of deterrence. In such areas it may be better not to rely exclusively on liability measures (*ex post* measures) and to bring preventive (*ex ante*) measures into the mix (Shavell, 1984).[26] In the following section, we begin our exploration of how these insights from the enforcement literature map on to the institutional and ownership contexts in India.

4. Contextualising enforcement of corporate governance in India

There are at least two issues we need to consider while examining the situation in India. First we need to contextualise whatever we do to address the kinds of corporate governance problems that arise in India. Second we need to contextualise the responses to the Indian judicial and regulatory landscape. There are other issues that would also possibly need to be considered (e.g. budgetary limits, political constraints), but we limit our inquiry to these two issues.

Governance context in India

Most of the publicly traded Indian firms are controlled by a group of shareholders, a family group, foreign entities, or the Indian government. Taking this into consideration, an enforcement policy should inquire into whether private enforcement would be as useful here as in dispersely held firms, whether one should consider criminal penalties in this context, and on what kinds of activities enforcement (public or private) should focus.

There are reasons to believe that private enforcement is likely to be quite viable in the Indian context. If obtaining enforcement relevant information is a plausible rationale for granting shareholders in dispersely held firms the power to initiate a civil suit, then that rationale should be even stronger for minority shareholders in controlled firms, since dispersed shareholders are less likely to have enforcement relevant information. The interests of the small shareholders in a dispersely held firm are such

that it is probably not worth their while to monitor the firm closely. This collective action problem is a common concern in dispersely held firms. However in controlled firms minority shareholders often have more shares than the average shareholder in a dispersely held firm, and hence would have greater incentive to monitor behaviour. Moreover it is easier to know who to monitor in a controlled firm—the controller—rather than in a dispersely held firm where the responsibility for behaviour may be more diffuse.[27]

Given the increased monitoring by minority shareholders, *non-shareholder parties* might not be expected to have additional enforcement relevant information that the shareholders do not already possess. This would reduce the desirability of a reward system. However it does not eradicate this need completely because some kinds of fraud are such that they require the assistance of third parties, and in such cases giving rewards to those who can help to break up the fraud would help. In addition some controlled firms in India may have many small shareholders (rather than minority blockholders) who may not monitor the firm that closely and for such firms a reward system may be worth considering.[28]

Further the liquidity enhancing features of private enforcement seem similar across dispersely held and controlled firms. Taking this point into account along with the arguments presented above would suggest that private enforcement could be quite beneficial in the context of controlled firms.

Another issue to consider is whether the kinds of harms are such that we might need criminal sanctions or early warning signals for controlled firms. Securities fraud and governance violations can generate very large losses (as in the case of the Enron scandal and the Satyam fraud), and this suggests that the availability of criminal sanctions and early warning signals (or other *ex ante* measures) would be desirable. Moreover where an attempt is being made to change (in some measure) the attitudes of those in control (of firms) criminal laws can play a role in sending a message/signal (Khanna, 1996; Packer, 1968). These seem to be good enough reasons to allow some criminal liability and to consider early warning signals.

A final point worth mentioning is one that has been raised many times in the extant literature on comparative corporate governance. The governance at controlled firms raises relatively different concerns than the governance at dispersely held firms. This suggests that the law and enforcement discretion should attend to the concerns that are most likely to be present in controlled firms (tunnelling risks, related-party transactions, for instance) rather than to those that surround dispersely held firms (like executive compensation, regulation of corporate control contests, etc.) (Bebchuk & Hamdani, 2009; Khanna, 2009a). This targeting or fine tuning of enforcement activity is discussed towards the end of this section after laying out how private and public enforcement can be enhanced in India given its institutional constraints.

Enforcement in the Indian Institutional Context

The analysis presented so far suggests that building private enforcement, using criminal laws more effectively, and developing early warning signals might prove beneficial in India. However these suggestions need to be tempered by the reality of the Indian institutional (and judicial) context.

Increasing private enforcement by relying on civil suits might be desirable in general, but given the lengthy delays in the Indian judicial system, any judgement would be so far in the future as to lose any real sense of recovery. The delays in the Indian judicial system are matters with which the Indian government and the parties involved in litigation have struggled for quite some time (Law Commission of India Report, 2008; National Mission for Delivery of Justice and Legal Reform, 2009). Until the judicial process is rid of these delays, we should consider alternatives to increasing civil liability through courts in India.

There are a number of options that could be pursued. A provision could be made for shareholder recovery through arbitral proceedings. The Stock Exchange Listing Agreement (SELA) could be amended by SEBI to require that firms and shareholders agree that when shareholders purchase shares listed on one of the Indian exchanges they will have all governance

and investor disputes determined by arbitration. This would be in addition to any enforcement SEBI or the other arms of the government might pursue.[29]

Arbitration offers a number of advantages over recovery through civil litigation (Haydock, 2000; Hylton, 2000; Shavell, 1995). First of all the procedures are more streamlined than in courts. Secondly arbitrators often have more specialised knowledge in the matter under dispute, whereas courts are usually composed of judges with less specialised knowledge. Additionally arbitration is not subject to the same delays as judicial decisions. Thus one option for private enforcement that does not rely on the courts is to have the arbitration provision made a part of the SELA. If some amount of flexibility is required, arbitration could be made the default provision in the SELA unless the firm and its shareholders contract around it.[30] Arbitration provisions are already available for firms listed on the Novo Mercado in Brazil and for firms in Delaware, and are required for firms domiciled in China which issue stock overseas; in fact, some firms in India offer arbitration as a method of resolving grievances with shareholders (Balasubramaniam et al., 2010 (in the context of India); Howson, 2008 (in the context of China); Pileggi, 2010 (in the context of Delaware); Millstein, 2005 (in the context of Brazil)).

Another method of enhancing private enforcement (which would not require arbitration) is to grant rewards to individuals who provide enforcement relevant information to the authorities. Although a well designed reward structure can benefit enforcement (Fitzner et al., 2007; Polinsky, 1980; Rich 2008), it does not by itself do much to address the liquidity based reasons for the provision of more direct compensation to shareholders (e.g. via arbitration). This is because the reward is given only to those people (shareholder and non-shareholder) who actually provided enforcement relevant information and not all shareholders who might be entitled to recovery via arbitral proceedings. Thus a reward scheme can supplement civil litigation or arbitration but not completely supplant it, at least for purposes of enhancing liquidity.[31]

However as a supplement, a rewards system could prove useful for extracting information from non-victim parties, for example from executives at the firm who do not own shares but possess information about wrongdoing. Some measures would need to be put in place to prevent misuse of the reward system as well as to reduce wasteful duplicative efforts by people to claim rewards (Fitzner et al., 2007; Polinsky, 1980; Rich, 2008).

Yet another option might be to encourage Stock Exchange enforcement. There is some measure of this in the United States where the Stock Exchanges have an enforcement (self-enforcement) role (Pritchard 2003, Mahoney 1997). Generally, exchanges are interested in enhancing trading volume and because investors are concerned about fraud one might expect exchanges to have strong incentives to reduce fraud to encourage more people to trade on their exchange. This suggests that delegating enforcement, in some measure, to exchanges could be beneficial.

However, for fraud or wrongdoing that is unlikely to reduce trading volume in the short run (e.g., "cornering" a market, self-dealing) exchanges incentives may not be optimal (Pritchard 2003, Pirrong 1995). Further, if there is a sense that the exchange may suffer from conflicts of interest, be beholden to certain large issuers, or be facilitating suppression of competition then the exchange's incentives may not be optimal (Pritchard 2003). Finally, even if exchange enforcement were a valuable enforcement option along with the others noted earlier, we should still keep in mind that it does not itself directly address liquidity concerns unless it provides for some compensation to investors.

Criminal Liability in the Indian Institutional Context

As was discussed earlier, criminal liability may be a useful supplement in cases of securities fraud and governance violations. Moreover the delays in the Indian judicial system for civil cases means that the expected sanction tends to become smaller. This is because the present value of a judgement far in the future is more severely discounted by litigants than a judgement closer to the present (to reflect the time value of money). The

lower expected sanctions raise the need to increase the actual sanction (e.g., use a criminal sanction). However, these same delays also lead us to be careful in using the criminal sanction. Such delays contribute to the rather low conviction rate in India for criminal cases. It appears that the long wait for a hearing can lead to witnesses' memories fading, evidence getting contaminated, and documents getting lost or destroyed.[32]

A low conviction rate makes the criminal sanction less useful both as a deterrent and as a message sending device. Failure to convict suggests (rightly or wrongly) that the government does not take the wrongdoing seriously. Moreover low conviction rates can make corruption easier—if conviction rates are low (and the enforcement authorities are not penalised for such low rates) then it becomes easier to arrest someone and dismiss the matter in exchange for a monetary payment or other benefits because convictions would not be expected as a general matter (Hylton & Khanna, 2007; Khanna, 2010a). If there are high conviction rates, then when someone is arrested the dismissal of the case would be likely to invite greater scrutiny because a dismissal would be an unusual event. The threat of greater scrutiny is likely to deter at least some people from dismissing a suit in exchange for payment.

If the standard to effectuate an arrest is quite low, it would contribute to generating a lower conviction rate and creating more scope for corruption to flourish, and this would also build up scepticism towards law enforcement. At present, criminal enforcement in India suffers both from low conviction rates and fairly quick arrests (Khanna, 2010a).

Although this is not an ideal forum to discuss reforms to the Indian criminal justice system, it does seem that greater scrutiny on arrests would be beneficial both because it would reduce the risk of being falsely arrested, and because such restrictions would reduce the number of people going through criminal proceedings (which should then speed up the process). The threat of criminal arrest and sanctions against tangentially connected independent directors are likely to help corruption flourish and deter qualified people from serving as directors.

In order to address these concerns criminal laws would need to be used sparingly and only against those who act in a clearly culpable manner, and the authority of the police to arrest hastily without compelling proof would need to be restricted. It would be worthwhile to consider locating the power to arrest for certain corporate offenses with another arm of the government, such as the Serious Fraud Investigation Office (SFIO) or the Central Bureau of Investigation (CBI). Although no agency is perfect, these offices are generally perceived to operate with a high degree of professionalism. In addition to limits on the power to arrest, we should consider imposing sanctions (and perhaps increasing them) for filing false reports with the police. Steps to constrain arrests and also to sanction people for providing false reports seem to be in the offing (Venkatesan, 2010).

Early Warning System

Even with these changes in place it could be that certain kinds of corporate and securities wrongdoing are so difficult to detect and would cause so much harm that we would prefer to prevent them ex ante rather than deter them ex post. Early warning systems may prove particularly valuable in India given the delays in other methods of enforcement. With such warnings, enforcement authorities and also perhaps investors can take their own protective or investigative steps and thereby interdict wrongdoing at an earlier stage so that the loss suffered is smaller and the need for large sanctions is reduced. The key lies in identifying early warning signals that can be operationalised (surveillance systems should be able to pick up these signs) and are useful to interdict wrongdoing.

Table 2 lists some suggested early warning signals that could be considered. The list is not meant to be exhaustive; it is indicative and is meant as a starting point for discussion.

Table 2: Proposed list of possible early warning signals

Early Warning Signals
Related-party transactions exceeding 5% of gross sales
Resignations of several directors
Off balance sheet transactions
Auditor change within 5 years
Decisions to withdraw an offering for equity or bonds
Restatement of results
Sudden trading volume changes by insiders
Promoters pledging shares
Sudden changes in business model(s) even without changes in profits preceding it

These factors can trigger alerts to enforcement authorities and perhaps the investing public so that the relevant audience can pursue it as they choose. Also these signals should influence how authorities direct their enforcement efforts in some manner.

Targeting Enforcement Discretion?

It would seem appropriate to guide enforcement discretion towards the major concerns in India at present and in the foreseeable future. The law and enforcement discretion should attend to the concerns most likely to be found in controlled firms (e.g. *tunnelling* risks) rather than those that surround dispersely held firms (e.g. executive compensation, regulation of corporate control contests). For the Indian situation in particular, enforcement should focus on self-dealing, related-party transactions, *freezeout* mergers, rules on veto rights, rules on nomination and selection of directors, rules on connections between controllers and directors, and rules related to separating cash flow from voting rights (e.g., pyramid structure, cross-ownership structures, dual class structures) (Bebchuk & Hamdani, 2009; Khanna, 2009a, 2009b). Matters such as executive compensation, control contests, rules examining connections between management and directors, and shareholder voting procedures (e.g. proxy voting) may be of greater importance to dispersely held firms, which are the minority in India (Bebchuk & Hamdani, 2009; Khanna, 2009a). With this additional targeting of enforcement discretion greater marginal benefits can be expected from the use of enforcement resources.

5. Conclusion

The efficacious enforcement of corporate and securities laws is an important factor in maintaining the health of capital markets. There is a general sense of dissatisfaction regarding the current enforcement situation in India. Given the tumult in the global financial markets and the frauds at Satyam and Nagarjuna Finance, this seems to be an appropriate time to consider the law and enforcement apparatus in India to enable Indian securities markets to continue to grow.

This paper began by providing an overview of India's current corporate and securities laws that address corporate governance concerns. The vast majority of enforcement in India occurs via various arms of the government, with essentially no private enforcement.

To determine whether this situation is desirable, we explored the literature on the economics of law enforcement. The literature suggests that in the corporate and securities area it would be beneficial to build private enforcement of some kind, to utilise early warning systems, and to provide for some degree of highly targeted reliance on criminal sanctions. This is because victims of wrongdoing may have information relevant for enforcement, and allowing them to bring private enforcement actions provides them with an incentive to come forward with that information. In addition prohibiting private enforcement could hamper the overall liquidity of the securities markets by causing investors to stay away from investing in markets where they cannot obtain compensation for fraud related losses (and where fraud seems to be a non-trivial possibility). Further the harm caused by governance concerns and securities fraud can be quite large and the optimal fine needed for deterrence may exceed the available assets of the defendants. Consequently the desirable sanctions are likely to include prison. Finally given the size of the likely harm from wrongdoing and the difficulty of designing a sanction large enough to deter it, we would be inclined to consider early warning signals that can be used to interdict the wrong before it causes harm that is difficult to remedy.

Although all these potential improvements are in theory desirable, they need to be operationalised within the context of the institutional

and other constraints found in India. The one key constraint is that the Indian judicial system does not move quickly enough to make new private civil enforcement via the courts a useful supplement. We suggest making arbitration a default term in all public company share purchases in India (as part of the SELA). This would help to ameliorate concerns regarding the speed of justice delivery in India. Non-victims may have enforcement relevant information, and they should be provided with incentives to come forward to SEBI with that information. One option would be to give a small reward to those parties providing enforcement relevant information who do not bring their own suits or arbitration proceedings (or who forgo such proceedings). Stock exchange enforcement in some measure should also be explored.

Another important constraint is that the criminal process is also quite slow, with quick arrests yet low conviction rates (when compared to other nations). This imbalance suggests the need for greater caution in using the power to arrest; the judicial process also needs to be speeded up. The latter is more difficult to achieve compared to the former. Therefore we suggest that the power to arrest for corporate and securities laws related issues should either be restricted or that power should be vested in specific authorities.

Finally we provide a list of potential early warning signals which SEBI and others (shareholders, and the media perhaps) could consider. Through such measures it would be possible to reign in corporate wrongdoing before it rises to a scale which becomes difficult to address.

All these measures need to be adjusted to focus on the kinds of governance concerns relevant to the Indian situation (e.g. related-party transactions, concerns associated with controlling shareholders). Adopting these steps along with other measures may help to enhance enforcement in India and thereby strengthen India's securities markets further.

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Notes

[1] For a broader discussion of how these factors interact in the development of active stock markets in India, see Khanna (2010b). For a discussion of important conceptual issues related to corporate law see Kraakman, et al (2009).

[2] Although this suggests that law and enforcement are important, one might be skeptical given the stock market growth witnessed in many countries (including India) where even after enacting corporate law reforms, there has been little enforcement. This pattern of law enactment followed by little enforcement with initial stock market growth usually exists for a very short time and for a variety of specific reasons which are explored in detail in Coffee (2001) and Khanna (2010b). However for stock market growth to continue and be sustainable law enforcement needs to start playing its role effectively.

[3] As the focus of research in this area turns to enforcement, scholars have begun to examine what aspects of enforcement matter most. However whichever features of enforcement matter most, it seems clear that those countries with better enforcement (however measured) tend to have more developed stock markets (Jackson & Roe, 2009). The question is why? There are many potential explanations—better respect for the law, political considerations, and so forth. A very likely explanation is that countries with more developed stock markets have better enforcement because the players in the market lobby for it. Under this view enforcement and stock market development have a much more bi-directional relationship, which is what is suggested by the historical evidence from the US and the UK (Coffee, 2001; Khanna, 2010b).

[4] There are other Acts that also provide the basis for regulation in the corporate governance sphere, but they are not as critical to the current discussion, and will be mentioned only in passing.

[5] See Sections 15T, 15U and 15Z of the SEBI Act (1992).

[6] Violations of Clause 49 can also lead to de-listing, but that has yet to happen in India. Clause 49 requires the inclusion of independent directors on corporate boards, defines independence (although with amendments over the years), and lays out some specific duties and obligations of the independent directors.

[7] To date, only 3 of these proceedings have been resolved (leading to no sanctions) (SEBI Press Release, 2007).

[8] See Sections 12A and 15G of the SEBI Act (1992), and Sections 3 and 4 of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations 2003.

[9] See Section 23C of the SCRA (1956), and Section 15C of the SEBI Act (1992).

[10] See Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, as amended in 2010 ("Takeover Code") Sections 45(5) and 45(6).

[11] For details, see Companies Amendment Act 2002; Union of India v. R. Gandhi, in the Supreme Court of India Civil Appeal No. 3067 of 2004 & Civil Appeal No. 3717 of 2005, May 11, 2010.

[12] For details, see http://www.rbi.org.in/scripts/Fema.aspx

[13] Similar comments may apply to regulators of other financial sector entities like insurance, pensions, etc.

[14] For details, see Tristar Consultants v. Vcustomer Services, AIR 2007 Delhi 157; Nanalal Zaver v. Bombay Life Assurance, AIR 1950 SC 172.

[15] For Satyam shareholders in India, their attempts to obtain monetary recovery from the National Consumer Disputes Redressal Commission (NCDRC) were rebuffed by the NCDRC on the grounds that it does not have the infrastructure to address this matter, and other government bodies (e.g. criminal authorities) are addressing it. The Supreme Court of India refused to overturn this outcome. (For details, see Midas Touch Investors Association v. M/S Satyam Computer Services Ltd. & Ors, Civil Appeal No. 4786 of 2009, in the Supreme Court of India, Aug. 10, 2009.) The Satyam fraud led to class actions in the United States as well; the outcome of these cases is pending as of date.

[16] See Sections 15Y, 20A and SEBI Act (1992), and 22E of SCRA (1956).

[17] Another conceptual possibility for private action is breach of fiduciary duties, but this too has limited significance. One reason is that these duties largely apply to directors not controlling shareholders in India and are very difficult to enforce (Varottil, 2009).

[18] For secondary market purchasers the parties are the shareholder who sells the shares and the new shareholder who buys them. These shareholders would not have engaged in the fraud; rather the firm, perhaps some executives, etc. would have been responsible.

[19] Section 62 of the ICA (1956) would provide no recovery because it requires the misrepresentation to be in a prospectus. Other matters that also impede shareholder suits are the absence of contingency fees which makes it difficult for smaller shareholders to find it worthwhile to bring suit, and the absence of a class action mechanism to aggregate shareholders claims making it financially unappealing to bring civil suits. The reforms proposed in the Companies Bill 2009 related to class actions (Section 216 of the Bill) do not substantially change the position for shareholders because the reforms allow for injunctive remedies not damages.

[20] After the Satyam and Nagarjuna Finance scandals, the perceived risk of potential arrest and the criminal liability for directors appears to have increased (Khanna & Mathew, 2010).

[21] Not every wrongdoing results in victims who can identify wrongdoers (e.g. environmental pollution), and in such instances private enforcement may have more limited value (Landes & Posner, 1975). Moreover public enforcement might be more useful when the detection of wrongdoing requires the development of information systems to monitor

activity (like nationwide databases) which might not be worthwhile for private parties to develop. Private parties might not have the incentive to develop such systems due to standard free riding concerns. Further force may be required to capture potential wrongdoers, and the government would prefer, for a variety of reasons, to be the sole agency authorised to use such force (Landes & Posner, 1975; Polinsky, 1980; Polinsky & Shavell, 2000). Another instance where public enforcement might be desirable is when allowing private enforcement substantially increases the risk of frivolous litigation, and the measures to curtail that risk are insufficient. This seems to be an exceptional situation because there should be other ways to address this besides prohibiting private enforcement. Also this would suggest that private enforcement does not bring forward sufficient valuable information.

[22] Moreover, since people are concerned about the speed and tenacity with which public enforcement moves, making that same enforcement the repository of all enforcement related information may raise concerns.

[23] A bounty system would not work as a substitute for private enforcement in this particular context because to match the liquidity enhancing effects of private civil litigation the bounty must go to all shareholders who suffered harm (not just the person providing information)

[24] Monetary sanctions involve the cost of transferring the money and this is usually considered fairly small (Becker, 1968; Shavell, 1985). Increasing monetary sanctions to a very high level might induce the chilling of desirable behaviour (Khanna, 1996), but we do not discuss that in much depth here; instead we focus on the importance of enforcement expenditures in increasing the likelihood of being sanctioned.

[25] It may prove useful to have criminal liability if the focus is on changing social behaviour because the criminal law would send a signal about what is considered acceptable behaviour in society (Khanna, 1996).

[26] Polinsky and Shavell (2008) among others discuss this and other related issues in detail.

[27] By analogy a similar argument can be made for public enforcement not needing as much information from private parties because public enforcers know who to watch (i.e. controllers). Although a plausible argument, the public enforcement authorities cannot monitor all firms all the time, but large minority shareholders have an incentive to monitor the controllers of those firms in which they have invested. Also such an argument does not address liquidity concerns.

[28] An alternative may be a derivative suit mechanism.

[29] The possibility of concurrent SEBI enforcement, criminal enforcement, and private enforcement could be achieved via legislative amendments to the SCRA (1956) and SEBI Act (1992).

[30] Another potential concern with arbitration is regarding where it might occur. In Delhi there are new arbitration forums that are beginning to be implemented and throughout India arbitration is gaining popularity as an alternative form of dispute resolution. Another option might be to make the situs of the arbitration the London Court of International

Arbitration (a body that Indian business is quite familiar with as it is a frequent situs for arbitration) (Khanna, 2009c). One may also consider designating a third party like a non-governmental organisation (NGO) to bring litigation on behalf of shareholders (Milhaupt, 2004). However if the recovery does not go to shareholders then we do not benefit from the liquidity enhancing effects of private enforcement. Another option may be to allow stock exchanges to monitor and enforce certain laws. This may also have some benefits (Pritchard, 2003), but again unless it provides for private recoveries it will not address the liquidity concerns. Moreover if information from victims cannot be easily obtained by the NGOs or the exchanges then again there is a need for some kind of private enforcement. In any case, exchange enforcement or NGO enforcement would have its own concerns and agency costs that might reduce their usefulness for enhancing enforcement. One advantage of both NGO and exchange enforcement is that the prospect of frivolous litigation is less than with purely private enforcement. If it were decided to design an arbitration regime it would be desirable to consider ways in which to limit the prospect of frivolous litigation.

[31] In addition it might be worth considering the provision of some measure of amnesty or sanction reductions for firms that come forward themselves about governance concerns at their firms. This would help to reduce enforcement costs for the government; also stopping governance problems early on can help to reduce the harm caused (Kaplow & Shavell, 1994). Such sanction reductions can be considered a form of reward as well.

[32] For details on delays in general see Priest (1989), and on accuracy in general see Kaplow (1994).

7

Corporate Governance and Market Value: Preliminary Evidence from Indian Companies

Alka Banerjee, Subir Gokarn, Manoranjan Pattanayak, Sunil K. Sinha

1. Introduction

If asked whether good corporate governance (CG) creates value, a majority of the responses would indicate that the link is not well-defined. But if asked whether bad corporate governance destroys value, the answer would invariably be in the affirmative. And this was once again demonstrated by the Satyam scandal in India in 2008–2009[1] (the Enron (2001) and WorldCom (2002) scandals had earlier proved this point). It would appear that weakness in corporate governance is a risk that neither the investors nor the government/regulators can ignore.

CG initiatives in India began in 1998 with the Desirable Code of Corporate Governance, a voluntary code published by the Confederation of Indian Industry (CII). In February 2000, the Securities and Exchange Board of India (SEBI) established the first formal regulatory framework for listed companies on CG (Clause 49 of the Listing Agreements) based on the recommendations of the Kumar Mangalam Birla Committee Report, 1999. In October 2004, these were revised following the recommendations of the Narayana Murthy Committee Report, 2003. More recently, in December 2009, the Ministry of Corporate Affairs, Government of India put forward guidelines on CG for voluntary adoption by the corporate sector in India.

According to the Cadbury Report, CG is defined as the "system by which businesses are directed and controlled" (Cadbury, 1992). In other

words, CG is a general set of customs, regulations, habits, and laws that determine how a firm should be run. In a broader sense, "Corporate governance is maximising the shareholder value in a corporation while ensuring fairness to all stakeholders, customers, employees, investors, vendors, the government and the society-at-large. Corporate governance is about transparency and raising the trust and confidence of stakeholders in the way the company is run. It is about owners and the managers operating as the trustees on behalf of every shareholder—large or small".[2]

As the *term corporate governance* lends itself to both broad and narrow interpretations, the appropriate management and control structures needed to bring about more transparency in a company's functionality are still unresolved issues. It is believed that good CG contributes towards a company's overall performance and sustainability, besides enhancing its access to outside capital. It has also been contended that CG serves a number of public policy objectives as it reduces vulnerability to financial crises, reinforces property rights, reduces transaction costs and cost of capital, and leads to capital market development (Javed & Iqbal, 2007).

Does the market then reward firms that practise good CG? In this paper we attempt to answer this question. In other words, our goal here is to test the hypothesis that firms with better CG practices receive better market valuations.

2. Review of literature

A number of studies have examined the relationship between corporate governance and firm performance (see Becht et al., 2003; Denis & McConnell, 2003; Gugler et al., 2004; Hermalin & Weisbach, 1991; Holderness, 2003; John & Senbet, 1998; Shleifer & Vishny, 1997, among others). Mitton (2001) in a cross-country study of the Asia-Pacific region found that firm-level differences in CG had significantly influenced firm performance during the East Asian crisis. The study also showed that higher price performance is related to higher disclosure quality, higher outside ownership concentration, and to firms that are focused rather than diversified. In a similar study Brown and Caylor (2004) looked at

2327 firms in the U.S. and found that better governed firms are also more profitable, more valuable, and pay higher dividends. Similarly Gompers et al. (2003) found that firms that have strong shareholders' rights have higher firm value, higher profits, and higher sales growth.

The number of independent directors is also often cited as proxy for good CG. Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) found that the market rewards firms for the appointment of independent directors. In a similar manner Anderson et al. (2004) found that bond yield spreads—used as proxy for cost of debt—are inversely related to board independence. On the other hand Fosberg (1989) found no relation between the proportion of independent directors and various firm-level performance measures. Hermalin and Weisbach (1991) and Bhagat and Black (2002) also found no link between the proportion of independent directors and value of the firm as measured by Tobin's Q.[3]

Thus, the evidence relating to board independence and firm value varies. The evidence pertaining to audit-related governance factors and firm performance is also mixed. However Yermack (1996) and Brown and Caylor (2004) found that the separation of the CEO's and the Chairman's positions in a company makes the firm more valuable.

3. Data and methodology

To examine the relationship between corporate governance and firm-level performance, we used the CG score obtained from the S&P ESG India Index[4] as proxy for firm level governance quality, and select financial indicators/ratios and Tobin's Q as measures of firm-level performance.

For our data analysis, we adopted two approaches. In the first approach, the firms were categorised on the basis of their CG scores, and their financial indicators/ratios were compared. The indicators/ratios that we compared were return on net worth, return on capital employed, profitability ratio (PAT/Income), and interest coverage ratio.

In the second approach, we used the fixed effect regression technique to empirically test the nature of the relationship between governance score

and market value as measured by Tobin's Q. In Tobin's Q measure, the market value of equity reflects the discounted present value of a company's expected future income stream. Therefore, Tobin's Q ratio takes into account the future prospects of the firm, and provides a measure of the management's ability to generate future income stream from an asset base (Short & Keasey, 1999). Since stock prices move in accordance with changes in expectations about future cash flows and the cost of capital, this is a forward-looking measure of a firm's performance. Thus a higher Tobin's Q indicates higher valuation by the market.

Despite several weaknesses in both financial and market-based measures, an increasing number of studies now rely on market-based measures. For instance, Demsetz and Lehn (1985) used accounting measures, but Demsetz and Villalonga (2001) shifted to market-based measures. As a result, we believe that the higher reliance on market-based measures is justifiable for two reasons. First, market-based measures are less prone to accounting variations and secondly, they reflect investor perceptions about the firm's future prospects.

The functional form of the model is as follows:

$$Q = \beta_0 + \beta_1 (Gscore) + \beta_2 \text{In} (sales) + \beta_2 \text{In} (age) + \beta_4 (Debt / Equity) + \varepsilon$$

where Q = Tobin's Q; *Gscore* = CG Score; *sales* = gross sales of the firm; *age* = year of observation minus year of incorporation; and *Debt/ Equity* = total debt of the firm divided by the total paid-up capital of the firm.

In this model Gscore is the key explanatory variable and the other variables are the additional explanatory variables. This model also includes sector specific dummies to control for any idiosyncratic industry specific effects.

4. Empirical analysis and results

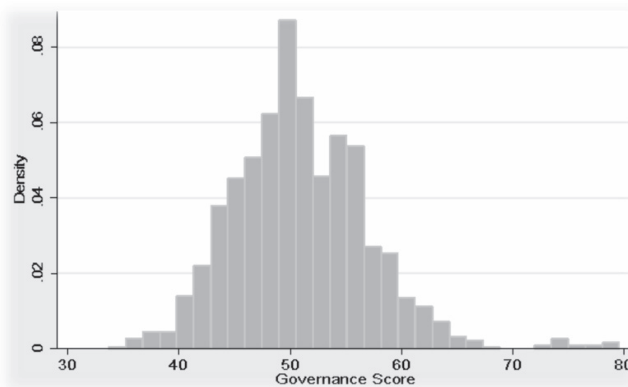
The distribution of the corporate governance scores is presented in Table 1. The minimum CG score in the sample is 33.7 and the maximum is 79.6. The coefficient of variation, which shows the spread in relation

to mean value, is 0.12. This means that the scores in the sample are distributed fairly symmetrically. The percentile distribution illustrates that approximately 25% of the firms have a CG score higher than 55, the scores of around 50% of the firms are between 46.9 and 54.7, and the remaining 25% of the firms have their CG scores less than 46.9. This percentile distribution is shown in Figure 1. Using this percentile distribution we divided the firms into three categories—Category 1 consists of the firms that have CG scores equal to or less than 45; Category 2 consists of the firms with a CG score greater than 45 but less than 55; and Category 3 consists of the firms with a CG score greater than or equal to 55.

Table 1: Summary statistics of corporate governance scores

Percentiles	Values	Smallest	Obs	1156
1%	37.57	33.7	**Mean**	51
5%	41.99	35.36	**Std. Dev.**	6.2
10%	43.65	35.91	**Variance**	38.9
25%	46.96	35.91	**Skewness**	0.8
50%	50.3	**Largest**	**Kurtosis**	5.0
75%	54.7	77.35		
90%	58.6	78.45		
95%	61.3	78.5		
99%	73.48	79.6		

Figure 1: Percentile distribution of governance scores



The summary statistics for the categories of firms mentioned earlier for the select financial indicators are presented in Table 2. The first indicator,

VARGP is the variance of the gross profit margin for the 12 quarters (FY 2005–06 to 2007–08). This indicates that the higher the variance, the less stable is the company's profit. Here we find that the firms belonging to Category 3 have the lowest volatility in the profit margin. The second indicator—the average profit margin (APROFIT)—is PAT divided by sales. Here also the performance of Category 3 firms is better than that of Category 2 firms, and is comparable to Category 1 firms. Besides these indicators, we calculated two more proxies of profit margins, RONW (PAT/Average Net worth) and ROCE (PAT/ Average capital employed). For this set also, Category 3 firms performed better than Category 1 and 2 firms.

Table 2: Summary statistics for three categories of firms for select financial indicators

Indicators	Category	Mean	Median
VARGP	1	52.8	16.4
	2	131.8	17.5
	3	45.3	23.8
APROFIT	1	12.2	10.3
	2	11.0	9.8
	3	12.1	10.4
RONW	1	18.9	18.5
	2	20.2	19.3
	3	25.4	20.2
ROCE	1	13.2	11.5
	2	15.0	12.6
	3	19.5	14.0
Debt/Equity	1	1.1	0.6
	2	1.0	0.6
	3	0.7	0.5
Interest Coverage Ratio	1	189.6	4.0
	2	165.7	6.9
	3	386.4	8.2
P/E	1	18.4	13.6
	2	21.3	18.7
	3	24.2	18.1
Yield	1	1.7	1.2
	2	1.7	1.1
	3	1.9	1.4

Debt/Equity Ratio is a measure of the indebtedness of the firm over its equity or base capital. Although there is no conclusive evidence to suggest that *less leveraged* firms are superior to *more leveraged* firms, our results show that firms with a higher governance score are less leveraged when compared to firms with a lower governance score. Interest coverage ratio is defined as PBIT/Interest payments. It measures how much interest payments can be covered by a company's profit, and indicates the financial soundness of the company[5]. Once again we find that firms having a higher governance score show a higher interest coverage ratio. In the case of Price-Earnings Ratio (P/E)[6] and yield, which is the return earned by the shareholders by way of dividends, we find that firms that have a higher governance score perform better than firms that have a lower governance score.

Table 3 shows the fixed effect regression results. There are industry specific effects[7] which have been controlled using the fixed effects estimation methodology. The model is highly significant as confirmed by the F-statistics. The coefficient of Gscore has a positive sign and is statistically significant, as was expected. This means that better governed firms do command a higher market valuation. *Ceteris paribus*, our regression results show that as the governance score goes up by a unit, the firm's value increases by 0.03 units.

Table 3: Fixed effect regression results

Tobin's Q	= 2.88	+0.03 x (G score)	-0.13 x (Log Sales)	-0.34 x (Log Age)	-0.06 x (Debt/Equity)
t-stat	(4.04)	(3.26)*	(-2.79)*	(-3.10)*	(-2.29)*

* Significant at 5% level; F-statistics = 7.80.

Other explanatory variables also turn out to be significant but are negatively related to firm performance. Although firm size—as measured by sales revenue—should have a positive relationship with a firm's value due to the advantages of economies of scale (Baumol, 1959), organisational inefficiency—called x-inefficiency (Leibenstein, 1966)—leads to loss of profit, a likely situation in larger firms. A firm's age could work either way. Old firms have the advantage of reputation, but they tend to be prone

to inertia and bureaucratic rigidities. We found the coefficient of Age to be negative, which means that younger firms (typically new age firms) command higher market valuation. In a Modigliani-Miller framework (1958), the market value of any firm is independent of its capital structure. If tax shields are precious, then the firm value should increase with the amount of leverage. However a high level of indebtedness may negatively impact investors' psychology. If the firm fails to credibly project its investment decisions leading to a positive NPV, then a higher amount of debt may drive down the value of the firm. We found a negative association between firm value and leverage.

To take a look at a more disaggregated relationship between Gscore and a firm's value, we considered Category 3 firms (CG score ≥ 55) as the reference category and regressed the Tobin's Q on two dummy variables[8] for Category 1 and 2 firms along with other explanatory variables.The result is presented in Table 4. The coefficients of Category 1 and 2 firms are negative. This means that the value of Category 1 and 2 firms is lower than that of Category 3 firms.

Further the coefficient of Category 1 firms is statistically insignificant. This means that the governance practices of firms having a Gscore less than 45 have no bearing on the firms' value.

Table 4: Disaggregated regression results

Tobin's Q	= 5.08	-0.40 x (Cat 1)	-0.38 x (Cat2)	-0.34 x (Log Age)	-0.12 x (Log Sales)	-0.07 x (Debt/Equity)
t-stat	(9.41)	(-1.62)	(-2.20)*	(-3.05)*	(-2.47)*	(-2.39)*

* Significant at 5% level; F-statistics = 5.10.

To arrive at a more precise relationship between Gscore and firm value we subjected the relationship to a non-linearity test. If a firm's value increases as the Gscore increases then the relationship between the two would be considered linear, and if it changes after a threshold then the relationship would be considered non-linear. We used the square of Gscore to examine the non-linearity relationship between Gscore and firm value. The results of this examination are summarised in Table 5. The coefficient of Gscore is negative while that of $Gscore^2$ is positive. Both coefficients

are statistically significant. This implies that there is a threshold beyond which a firm's value increases with an increase in governance score. This suggests that investors assign a premium on the firm's value when the governance score crosses a threshold.

Table 5: Regression results of non-linearity test

Tobin's Q	= 11.01	-0.26 x (G score)	+0.002 x (G score2)	-0.16 x (Log Sales)	-0.35 x (Log Age)	-0.07 x (Debt/Equity)
t-stat	(3.88)	(-2.55)*	(2.96)*	(-3.20)*	(-3.18)*	(-2.42)*

* Significant at 5% level; F-statistics = 8.03.

5. Conclusions

Although corporate governance has gained substantial ground in developed economies, it has begun to make an impact in emerging markets like India only relatively recently. Corporate governance formally became a part of the regulatory framework for Indian listed companies with the introduction of Clause 49 of the Listing Agreements in February 2000. However very limited evidence exists as to how CG practices have impacted firm-level performance or valuations within the Indian context. This study attempts to fill this gap.

To examine CG practices and their impact on firm-level performance we used the CG score obtained from the S&P ESG India Index as proxy for firm-level governance quality. Our results show a positive and significant relationship between CG score and firm-level performance after controlling for a number of firm-specific and time-specific factors. Better governed firms not only command a higher market valuation but are also less leveraged and have higher interest coverage ratios. Further they provide a higher return on net worth and capital employed, and additionally their profit margins are relatively more stable. Finally their Price-Earnings Ratio (P/E) and yield—the return earned by the shareholders by way of dividend—are also higher in comparison to the firms whose CG score is lower.

Though preliminary, these results are significant in at least three ways. First they suggest that investors are actually using the information

available from companies on their governance practices to differentiate between companies. This would imply that companies had an interest in improving their corporate governance practices as well as in publicising the measures that they take since this would contribute to an improvement in their market valuations.

Second the existence of a threshold effect indicates that only those companies that are above a certain threshold of governance levels receive the premium which provides a rough benchmark for the mandatory disclosure requirements that the regulator sets. A closer examination of the scores received across specific governance indicator categories would help to identify the kinds of behaviour and disclosures that investors put the highest premium on.

Third the Indian market, like most emerging markets, is a mix of domestic and foreign investors. To the extent that global investors put a premium on the governance of the companies they invest in, their strategies may have some positive spillover effects on domestic investors who may be trying to replicate them. We cannot of course address this issue definitively in the Indian context based on our limited data, but there is an important implication in following this line of thinking—the more significant the presence of investors who value good governance, the more likely it is that good governance practices will spread across the broader community of investors. This aspect may support an argument for regulatory mechanisms that encourage such investors.

Notes :

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Notes

[1] In one of the biggest corporate governance scandals in India's corporate history, B. Ramalinga Raju, founder and CEO of Satyam Computers (India's fourth-largest IT services firm), announced on January 7, 2009 that his company had been falsifying its accounts for years, overstating revenues and inflating profits by $1 billion. Raju was compelled to admit to the fraud following an aborted attempt to have Satyam invest $1.6 billion in Maytas Properties and Maytas Infrastructure—two firms promoted and controlled by his family members. On December 16, 2008 Satyam's board cleared the proposed acquisition, sparking negative reactions from investors and Satyam's stock plummeted on the New York Stock Exchange and NASDAQ. The board hurriedly reconvened the same day and called off the proposed investment.

[2] N. R. Narayana Murthy, Chief Mentor, Infosys Limited (http://www.nfcgindia.org/aboutus.htm)

[3] $$\text{Tobin's } Q = \frac{\text{MV of Equity + BV of Debt}}{\text{BV of Total Assets}}$$

[4] The universe for the S&P ESG India Index comprises the NSE listed top 500 Indian firms as per market cap on the last working day of each financial year. These firms are evaluated against a screen comprised of corporate governance, environment, and social parameters for their disclosure pattern and performance. For this study, we have used the data relating to the corporate governance screen only. The corporate governance screen consists of 127 parameters, of which 27 are extra point parameters. The screen covers various facets of corporate governance such as shareholder capital, shareholder rights, financial information, operational information, board and management information, board and management remuneration, corruption, leadership and business ethics, etc. A firm gets a score of 1 for disclosure on a parameter of the screen and zero otherwise. For the extra point parameters, a firm gets a score of 3 for disclosure and zero otherwise. The total scores obtained by the firms indicate their relative corporate governance quality. The maximum score that a firm can get is 100 and the minimum score is zero. Currently these scores are available for four years (2005, 2006, 2007, and 2008) and the common set (our sample) consists of 279 firms.

[5] If some of the borrowed funds are invested in projects where the gestation period is long with a greater probability of higher return, then this static measure will not capture that.

[6] Price-Earnings Ratio (P/E) is a forward looking measure. It shows the premium paid by the investors to own a share on the basis of the anticipated cash flow of a company.

[7] This is confirmed by the F-test where the null hypothesis of no fixed effects is rejected.

[8] The dummy variables have been created in the following manner: Cat 1 = 1 if Gscore < 45, otherwise = 0; Cat 2 = 1 if Gscore ≥ 45 and < 55, otherwise = 0; Cat 3 = 1 if G score ≥ 55, otherwise = 0

8

Risk Governance at Financial Institutions: Life after the Subprime Crisis

Dipinder S. Randhawa

1. Introduction

The speed and severity with which the subprime crisis spread across financial markets and institutions, transcending national boundaries, caught market participants, policymakers, and researchers by surprise. The causes and consequences have been extensively documented with a broad consensus on the factors that triggered the crisis, and the channels through which it spread across the global economy (Robertson, 2008; Bailey, et al. 2008). The debate has now turned to policy interventions seeking to address the root causes of the crisis, and the measures that can be initiated to minimise damage inflicted by future crises.

The poor performance of sophisticated quantitative models and the inability of bank management and regulators to identify the latent fragility in the financial system led to attention being focused on the links between corporate governance and risk management. A commission established by the Institute of International Finance (IIF) noted that "Failures in risk management policies, procedures, and techniques were evident at a number of firms. In particular, the lack of a comprehensive approach to firm-wide risk management often meant that key risks were not identified or effectively managed." (IIF, 2008, p. 10). Following an examination of decision-making within financial institutions, the commission stated unequivocally that it was "critical for governance to embed a firm-wide

focus on risk. The recent market turbulence has provided clear evidence that effective cultivation of a consistent 'risk culture' throughout firms is the main enabling tool in risk management" (IIF, 2008, p. 11).

The impact on India's financial sector—especially banks—was limited. However as the economy continues to liberalise and integrate with the global economy, there are important lessons to be learned. The crisis underscored the need for effective monitoring of risk within financial institutions. There is much to be learned from the experiences of regulatory systems and institutions in developed as well as emerging market economies that were successful in escaping the ill-effects of the crisis. As India embarks upon the next generation of reforms, it would be useful to be cognizant of the new and evolving risks the economy could face as it integrates with global financial markets.

This paper assesses the experiences of the Indian banking sector during the global financial crisis of 2007. The focus is on the links between corporate governance and risk management. The complex nature of the governance of banks requires an approach going beyond the confines of the traditional constructs of corporate governance that concentrate on the role of senior management and the board of directors. Bank governance should encompass the design and effective implementation of risk management policies, compliance with regulatory policies and supervisory norms, and cross-border regulatory issues necessary to ensure stability. The approach to governance in this paper thus encompasses public governance—defined here as including bank regulation, the design of the institutional infrastructure within the bank that facilitates risk management, as well as corporate governance. The embedded assumption is that significant regulatory changes are necessary to improve standards of corporate governance, and principles-based standards of conduct alone are inadequate given the complex nature of banking. An explanation of the rationale of this approach is provided below.

We start with an overview of the literature on the governance of financial institutions, with a focus on risk management. This provides the context for the paper and helps locate it within the broader debate on

governance, risk management, and performance of financial institutions. As recent experience has shown, this has implications for the performance and stability of the domestic financial system. In an era of globalisation it has ramifications for systemic stability and resilience to external shocks, especially of the type experienced during the subprime crisis. This is followed by a brief account of the global financial crisis. We describe the response of the monetary and regulatory authorities, and then focus on issues germane to the governance and risk management of financial institutions. An account of the channels of transmission of the financial crisis is followed by an analysis of how effects of the crisis were mediated by the structural and institutional characteristics of the Indian banking system. The concluding section provides some policy prescriptions that can be gleaned from the experiences over the past two years.

2. Corporate governance and risk management in banking

Failures in governance, regulatory oversight, and risk management are acknowledged to be central to an understanding of the crisis (IIF, 2008; IMF, 2009; Kirkpatrick, 2009). Governance failures occurred in developed economies with the most sophisticated financial institutions. The ongoing debate on reforms is considering comprehensive changes in the way financial institutions are regulated and governed—reforms that may constitute a paradigm change in the nature of governance of the financial sector.

Sound corporate governance "encompasses institutions and practices designed to ensure that those running companies serve the interests of those who own them" (Litan et al., 2002, p. 2). Corporate governance encompasses institutions, regulatory structures, establishment of incentive structures, and adherence to codes of conduct and fair business practices. While corporate governance has received a great deal of attention in the media and in research, the governance of banks has been curiously neglected (Caprio et al., 2007; Barth et al., 2004, 2008) While this may appear puzzling, an examination of the issues and challenges surrounding governance of financial institutions sheds light on this issue.

Banks are complex institutions; three characteristics distinguish them from other firms. Banks are extremely opaque, highly leveraged, and they are extensively regulated. Each of these traits has a bearing on the governance of banks. Further, through their operations and the resultant impact on the economy, banks engender strong externalities.

Opaque portfolios

The value of a bank portfolio is extremely difficult to gauge. Share prices are generally reliable indicators of the health of non-financial firms, however in the case of financial institutions capital markets have often failed to detect (let alone predict) incipient problems. The Asian Financial crisis of 1997–98, the repeated crises in Latin America through the eighties and the nineties, the crisis in the Scandinavian banking system in the early nineties, the subprime crisis of 2007, are all instances where capital markets did not provide any indication of the problems brewing within banking systems. It is challenging to assess the strength of a bank's balance sheets with a degree of accuracy comparable to that which can be achieved for non-financial firms. The quality of loans—the main assets for most banks—is not easily observable and can be kept hidden for extended periods of time. A widely used stratagem is the process of ever-greening of loans, whereby banks extend new loans to cover missed interest payments, subsequently reporting the loans as new assets. Banks can also rapidly alter the risk composition of their assets through market trades. Money-centred banks often tend to engage in such behaviour using short-term borrowings. As recent experience with securitisation of loans demonstrated, banks can take on risks, and transfer them through repackaging securities, on to other participants in the financial system (or financial markets). Thus the opaqueness of bank portfolios makes it difficult for outsiders to monitor bank's financial health.

High Leverage

Bank fragility is heightened on account of the high degree of leverage they carry. Their liabilities are primarily in the form of deposits and (in the case of larger banks) interbank loans or borrowings in money markets.

Securitisation of loans has enabled banks to further increase leverage. During periods of uncertainty these loans can dry up abruptly; banks also face the risk of runs on deposits. The high degree of leverage compounds a bank's vulnerability to external shocks; liquidity problems can quickly turn into solvency problems, threatening the very existence of banks. Poor credit decisions lead to misallocation of capital, thus hampering prospects for growth. Guaranteeing of bank deposits with what are effectively public funds further necessitates public oversight. Monetary authorities justify deposit insurance on the grounds that it precludes incentives for runs on banks deposits.

Regulation

Problems in the banking sector can generate strong externalities that permeate the economy. The consequences of the failure of a large bank are very different from the effects, for instance, of the failure of a large steel plant or an airline of the same size. Bank failures result in drying up of liquidity. This can result in non-financial firms find themselves unable to access credit—the lifeline for the corporate sector. Small or medium sized firms that hold very limited cash reserves and are unable to access liquidity through other channels are especially vulnerable to changing credit market conditions. This was vividly evident in the severe impact of the credit crunch on the SME sector in the affected economies. For non-financial firms the inability to obtain funding from banks during the crisis created serious liquidity problems, leading to potential solvency problems.

The externalities generated by a bank's operations, especially in the event of a banking crisis, necessitate extensive regulation. Bank stability can thus be seen as a public good. Banks play a pivotal role in the execution of monetary policy; their lending decisions determine the type of investment projects that are undertaken in an economy. Thus banks have a powerful impact not only on financial stability, but also on growth prospects in an economy. Banks are, and in the foreseeable future will continue to be, among the most extensively and intensively regulated entities. This is reflected in the power accorded to regulatory agencies, the emergence of international accords such as Basel I and Basel II, and state ownership of banks.

The opaqueness of bank portfolios coupled with the high degree of leverage underscores the need for regulation and close supervision of bank activities. The recent financial crisis has revealed the vulnerability of banks to developments in the macro economy, elsewhere in the financial sector, and indeed, in the global economy.

Unique challenges in governing bank behaviour

The negative externalities that result from bank failures necessitate higher standards of governance than required in the case of non-financial firms. Problems at banks almost inevitably arise on account of flaws or lapses in risk management. This could be due to poor assessment of credit risk (as witnessed during the Asian Financial Crisis of 1997–98), or unhedged exposure to derivatives (Allied Irish Bank), poor foreign exchange risk management, or plain fraud, neglect of credit risk and systemic risk (the subprime crisis of 2007), or inadequate liquidity risk management (the subprime crisis again). Prudential regulation and supervision, and the role of market discipline in bank monitoring and governance inextricably links risk management with corporate governance and regulation.

Corporate governance of banks entails challenges that are substantially different from the governance of non-financial firms (Demirguc-Kunt et al., 2004; Erkens et al., 2009; Laeven & Levine, 2008). The traditional focus on shareholder value or on conflicts between shareholders and debt holders offers an incomplete picture of governance problems at banks. The presence of safety nets in the form of deposit insurance or an implicit guarantee in the case of state-owned banks, as well as the ‘too big to fail’ approach to dealing with potential bank failures distinguish banks from other firms. The indirect costs of a bank failure are borne by the economy, manifest in a reduced supply of credit and a slowdown in investment and loans to finance consumption expenditures. The direct costs in the form of payments to depositors, or government assuming control over failing banks or capital injections fall upon the exchequer.

Stakeholders in banks are different from stakeholders in other corporate entities. Aside from shareholders and bondholders; depositors,

regulators, the government, and the broader public all have a direct interest in ensuring the viability and stable functioning of banks. Banks generate profits by intermediating funds and taking risks. Profits from bank investments are directly related to the level of risks taken. Incentive structures for bankers lead them to take on risks with the benefits from risky investment strategies accruing to bank management, and the losses being borne by the broader economy. As an influential commentator put it, "this is the only sector where the gains are private, and the losses are socialised" (Wolf, 2008). These deposits are insured, invariably by a government-owned institution. As current and past crises have demonstrated, in episodes where bank deposits were not explicitly insured, a financial crisis or looming bankruptcy would inevitably result in the government stepping in to provide guarantees to depositors in order to ward off a run on deposits. The presence of deposit insurance creates moral hazard problems, inducing banks to take on excessive risk secure in the belief that a positive outcome would yield substantial profits, while the costs of a severe loss —even one jeopardising bank solvency—would be borne by the government, either through deposit insurance or through a bailout of the failing bank. Thus sound internal controls and effective corporate governance complemented by external supervision and regulation are vital for the effective governance of banks.

Link between bank governance and risk management in banks

This paper takes the stand that effective governance of financial institutions requires a coordinated approach between corporate governance and public governance, the latter being manifest in the nature of the regulatory regime. Experience shows that sound risk management in banks is an extension of effective governance. This is clearly evident from Basel II and the banking reforms that have been proposed in the aftermath of the subprime crisis. An examination of the governance of banks necessarily has to be located in the broader context of risk management and public governance. The unique characteristics of banks—opaque portfolios, high leverage and extensive regulation—and the manifestations of systemic effects in the event of a banking crisis suggest that bank governance

requires a unique approach, encompassing both public as well as corporate governance. In our approach, public governance is reflected in the design of regulation and the effectiveness of regulatory authorities. The subprime crisis has graphically demonstrated how risk management is central to governance of banks. Effective risk management entails not only monitoring of a bank's operations but also ensuring adherence to regulatory norms and principles of supervision prescribed by the monetary authorities. This is important since in the recent crisis banks were vulnerable to systemic and liquidity risks that developed on account of aggregate activities in the financial system, well beyond the purview of individual banks. The last two years have demonstrated how failures in regulatory oversight shaped the response of banking systems to the subprime crisis.

Three points provide the rationale for our approach. (1) Research on the subprime crisis (including Stulz, 2009, among others) reveals that national regulatory regimes rather than bank-specific characteristics had a stronger impact on bank performance and the stability of the banking system. Economies such as Canada and Australia, though deeply integrated with the global economy, escaped the worst of the crisis. This was largely due to the regulatory restrictions governing the levels of leverage, and limits on the exposure to off balance sheet activities. (2) Studies conducted at the IMF (2009), the World Bank (Stephanou, 2010), and by other researchers on the experiences with financial crises since the early eighties, show that a crisis spreads rapidly across banks within a country, given the strong linkages across banks via the interbank market, money markets, and depositor behaviour. During times of financial stress, bank level differences were quickly subsumed by the systemic nature of the crisis. The effectiveness of domestic regulation and structural characteristics—in particular the business model adopted by the bank—determined the severity of the impact of the crisis. (3) Extant research shows that the effectiveness of bank level governance is defined by the prevailing supervisory regime, and the extent to which regulation and prudential supervision are executed by the monetary and regulatory authorities (Barth et al., 2004, 2006). Given the nature of banking, this has an important bearing on the stability of the banking system, and thereby on the financial system and the economy.

Thus the starting premise for this paper is that corporate governance of financial institutions is inextricably tied up with broader issues of regulation (public governance in the context of the financial sector), and together they have a profound impact on risk management in financial institutions.

Banks are affected by developments and risks such as liquidity and systemic risk, that are external to the bank and beyond its scope and capabilities to monitor or regulate. The identification and management of these risks require regulatory intervention. This creates a need to redefine the role of governance of banks. The traditional banking model—where the bank is a stand-alone entity—is clearly inadequate for the existing realities of financial markets and institutions. The development of the 'shadow banking system' through which risks were transferred from banks to financial institutions and capital markets further reinforces the need for an approach that integrates corporate governance with public governance (regulation).

3. Global Financial Crisis

The origins of the 2007 crisis lay in subprime mortgages extended by banks in the United States. These loans accounted for nearly 80% of the mortgages extended by financial institutions. A large proportion of the mortgages that were based on adjustable rates started defaulting when interest rates began to increase in early 2007. The default rates accelerated as the initial discounted terms expired and repayments were subject to higher prevailing market rates.

The rapid proliferation of these mortgages was facilitated by low interest rates complemented by lax lending criteria. A steady flow of liquidity was provided by the sustained, increasing inflows of funds from overseas. This is a corollary of what is commonly referred to as a 'global imbalance' - a substantial and widening US trade and budget deficit financed by overseas purchases of US treasury securities. The availability of easy cash and low interest rates, reinforced by growth in the real economy, fuelled a housing bubble. The bubble burst when interest rates rose towards

the end of 2006 and early 2007. The number of foreclosures accelerated rapidly. The problem was compounded by the development of a shadow banking system in which investment banks and hedge funds played a vital role in adding fragility to the financial system. These non-bank finance institutions provided funds to the housing market by underwriting and buying the securitised products. They were unregulated, and unlike banks were not subject to stringent capital adequacy and disclosure requirements. Further subprime loans, by their very nature were high credit risks. The shadow banking system did not have the resilience to withstand loan defaults that could not be detected until it was too late. This substantially compounded fragility in the financial system.

The risks to the broader economy, including institutions outside the United States stemmed from investments in derivative products arising out of subprime mortgages. Most transactions outside the banking system fell beyond the purview of regulatory oversight. Investments in these products by major multinational banks around the globe, and the underwriting of credit default swaps by insurance companies, resulted in growing systemic risk. Moral hazard problems within the banking system and the shadow banks underlay much of what transpired in the financial system, as lending fuelled by easy cash and complete neglect of prudential norms led to the growing housing bubble. The communiqué issued by theG20 leaders pointed towards severe lapses in governance and risk management, as well as policy errors earlier in the decade as the core causes of the crisis. (G20 Communiqué, 2009).

The Global Financial Stability Report published by IMF in early 2009 (IMF, 2009) estimated total losses on account of the crisis at over $4 trillion. As bond and equity prices fell and the interbank market dried up, panic spread among investors and financial institutions. The rapid increase in redemptions at mutual funds and hedge funds led to abrupt outflows from emerging markets, triggering sharp falls in equity markets around the world. Liquidity dried up as banks and other financial institutions scrambled to meet their obligations, resulting in nervousness in financial markets and rapidly increasing interbank rates. Panic about the credit

worthiness of even blue chip borrowers led to a virtual freeze in money markets. The impact on emerging markets including India was sharp and swift. Deleveraging resulted in sharp cutbacks in the flow of funds to emerging market economies.

In emerging market economies including India, the initial belief was that Asia had 'decoupled' from the West, reflected in a negligible economic spillover. However during the latter half of 2008, the collapse of Lehman Brothers accentuated the impact of the crisis. It was soon felt in emerging market economies through increasing interest rates, tightening credit market conditions, and cutbacks in exports (Dooley & Hutchison, 2009). Dooley and Hutchison's sample of fourteen emerging markets did not include India; however the response of Indian markets coincides closely with that of the other emerging markets. The results suggest that the emerging markets had decoupled till the collapse of Lehman Brothers; subsequently, the study shows strong linkages between developments in the US market and the cluster of emerging markets in the sample. The links manifested themselves initially through credit markets, and following the economic slowdown, soon after were transmitted onto the real sector.

4. Impact on India

Notwithstanding the effects of the recession in developed economies and the global liquidity crisis, India was relatively unaffected by the global financial crisis. Whether this was due to the policy interventions or regulatory oversight, structural factors, or plain luck merits scrutiny.

Over the past two decades India has gradually integrated into the global economy. Trade barriers have been substantially lowered, though compared to the economies of East and Southeast Asia, India still remains relatively closed. The dependence on trade as an engine of growth is low. Trade as a percentage of GDP has grown from 13% of GDP in 1991 to 30% of GDP in 2008. The current account measured by current receipts and payments rose from 19% to 53%, and the capital account rose from 12% to 64% over the same period. Compared to the neighbouring economies of Southeast Asia, Latin America, or the European economies, the Indian

economy may be deemed partially open with growth tied to domestic demand. While full capital account convertibility may still take some time, the current account is open. Foreign direct investment has been growing steadily over the past several years. The restraints on capital account convertibility and the relatively small proportion of trade as a proportion of GDP helped the economy survive the worst effects of the subprime crisis.

Indian banks with very little exposure to subprime mortgages or products derived from these mortgages were relatively unaffected by the subprime crisis. The two largest banks which also happen to have relatively significant operations in overseas markets—ICICI and the State Bank of India (the largest state-owned bank)—had total exposure to credit derivatives amounting to $2.5 billion. Table 1 provides details of the subprime exposure of some of the major Indian banks; the data was compiled from publicly available media reports. The losses were on account of marking to market. As the credit crunch persisted, firms found it increasingly difficult to obtain bank loans. In order to augment the supply of liquidity, stimulate lending, and strengthen the capital reserves of banks, the Government of India negotiated a $4.3 billion loan from the World Bank in the last quarter of 2009, of which $2 billion was earmarked for bolstering the capital bases of state-owned banks.

Table 1: Subprime exposure

Subprime Exposure			
	Exposure*		**Provisioning ** (Rs crore)**
	$	Rs crore	
ICICI Bank	1.5 billion	6,000	100
SBI	1 billion	4,000	NA
Bank of India	300 million	1,200	5-6
Bank of Baroda	150 million	600	60

* Exposure to credit derivatives (estimated)—the mark-to-market losses on these portfolios could range from 5 to 10%.

** Provisioning for quarter ended September, 2007.

A study by the Reserve bank of India (RBI, 2010) revealed that aside from the few large banks mentioned earlier, none of the other Indian banks had exposure to subprime loans. In the case of the large banks, the losses were due to investments in collateralised debt obligations (CDOs) issued by institutions with subprime exposures. The losses among Indian banks came to the fore when marking to market. Subsequent to the collapse of Lehman Brothers, banks were advised to report their exposure. Out of 77 banks, 14 reported exposure to Lehman or related entities, most of which were not covered by the Chapter 11 filings by Lehman Brothers. The relative insulation of the banking sector also precluded the contagion effect that was manifest much more strongly in East and Southeast Asian banks.

RBI has pursued a conservative, gradual and calibrated approach to financial liberalisation. The capital account is partially open. The main source of fragility emerged through portfolio investment flows, also known as “hot money”. Indian companies had borrowed heavily in international debt markets in the form of “external commercial borrowings”. The substantial volume of foreign exchange reserves built up over the past decade has provided a cushion and buffer against sudden capital flows.

The initial impact was felt through financial markets as foreign institutional investors rapidly withdrew in response to redemptions and accelerating deleveraging by investors in mutual funds and hedge funds. After the collapse of Lehman Brothers, and the resultant tightening in money markets, the impact was quickly transmitted through money markets resulting in tighter conditions in credit markets.

As indicated in Table 2, the sharp reversal in capital flows was instrumental in transmitting the effects of the subprime crisis to India. This also posed additional challenges to the RBI’s is efforts to maintain stability in currency markets. As shown in Table 2, total capital outflows were to the tune of $13b in 2008. This was the first time since 1997 that there was a net outflow of funds by Foreign Institutional Investors. This resulted in pressures on the domestic credit markets as well, and the interbank rate rose to 20%. It wasn’t until the RBI intervened by cutting both the

statutory liquidity ratio (SLR) and the cash reserve ratio (CRR) that pressures on the credit markets eased. Larger firms experienced serious challenges in raising funds in international markets. This was evident even for a highly rated group such as the Tatas, which eventually had to seek recourse to expensive debt in the domestic market. A sizable buffer of foreign exchange reserves and healthy domestic economy thwarted any concerns about debt servicing, a reflection of how far the economy had come since the crisis in 1991.

Table 2: Trends in capital flows (in $ million)

Component	**Period**	**2007-08**	**2008-09**
Foreign Direct Investment to India	April–August	8,536	16,733
FIIs (net)	April–Sept 26	15,508	-6,421
External commercial borrowings (net)	April–June	6,990	1,559
Short-term trade credits (net)	April–June	1,804	2,173
Memo			
ECB approvals	April–August	13,375	8,127
Foreign Exchange Reserves (variation)	April–September 26	48,583	-17,904
Foreign Exchange Reserves (end-period)	September 26, 2008	247,762	291,819

The data on FIIs presented in this table represent inflows into the country and may differ from data relating to net investment in stock exchanges by FIIs.

The impact on the real sector was felt through three channels—trade, finance, and confidence in broader market conditions. Trade was reflected in falling exports and demand for IT outsourcing. Low confidence in market conditions was reflected in falling asset prices, as well as a migration of funds from private banks to state-owned banks, triggered by the belief that government banks were safer. The overall effect on the Indian economy was muted as growth in India had been more dependent on domestic demand and investment financed through domestic savings.

In the real sector, the abrupt slowdown in the West led to sharp falls in exports and outsourcing—the mainstay for the Indian software industry. The problem was briefly compounded by fraud and governance related issues at Satyam Computers.

The government and the monetary authorities were quick to respond. The authorities sought to increase liquidity and provide easier access to the sizable currency reserves. This was complemented by a substantial fiscal stimulus. RBI intervened by lowering the cash reserve ratio and the statutory liquidity ratios so as to inject liquidity into the economy, and to increase the supply of loanable funds. RBI also intervened through open market operations to bolster liquidity. The liquidity adjustment facility (LAF) and the market stabilisation scheme (MSS) were deployed to mobilise funds. Notwithstanding the ongoing turmoil in the global financial system, it is noteworthy that the authorities declared their intent to continue liberalising the capital account and implementing further reforms in the financial sector.

Prudent loan loss recognition norms had already helped lower the proportion of non-performing loans. By mid-2008, when the full impact of the crisis was felt in India, banks were well capitalised, with average Tier 1 ratios exceeding the Basel accord requirement of 8%. The government was quick to step in with refinancing facilities and credit guarantees to maintain the vital flow of credit to the SME sector as well as other enterprises.

The government also introduced a fiscal stimulus, in the form of tax cuts, enhanced investment in infrastructure, and a broad based increase in government spending. Three rounds of fiscal stimuli were initiated between December 2008 and March 2009.

5. Analysis of developments in India

Why was India relatively unaffected by the crisis?

Public Governance

The overarching objective of monetary authorities in India has been financial stability. The fact that a large proportion of the population lies below or close to the poverty line renders economic well-being and stability extremely sensitive to inflation. Price stability is considered vital for economic and political stability, and for creating an environment conducive to investment. The underlying belief that informs policy

formulation is that the health of the financial sector is contingent upon prospects in the real sector. This perspective has resulted in a cautious gradualist approach to financial liberalisation.

Indian banks continue to remain well capitalised. By March 2009, common equity accounted for 7% of risk capital against the norm of 3–4% for most international banks. Tier 1 capital reserves were 13.75% against 9.4% for large multinational banks. The leverage ratio was at a judicious level of 17%. With high capital reserves, Indian banks were well equipped to deal with the initial losses as some borrowers started to default on loans. In spite of the early problems at ICICI bank and the State Bank of India, the banking system remained well capitalised at levels significantly above those mandated by the Basel accord. Increased provisioning against nonperforming loans that had been implemented earlier helped to sustain confidence in the banking system,

Approximately 70% of banking in India continues to remain under state ownership. Though the market has opened up to new private sector banks, foreign banks are allowed only on a case by case basis. Existing foreign banks have been allowed to expand operations, and licenses extended to new entrants. The Indian rupee is fully convertible on the current account, and partially convertible on the capital account; however full capital account convertibility is unlikely to take place in the near future. Thus a major channel of transmission of financial instability does not exist. The convertibility restrictions keep the debt markets relatively insulated from global financial markets thereby limiting contagion effects and moderating the adverse effects of the global crisis.

Indian banks have traditionally followed conservative strategies in international markets as well as in the domestic arena. Limited levels of off balance sheet activities and the small market for complex derivatives coupled with low leverage ratios kept the risk profiles of banks at modest levels, compared to larger multinational banks. The limited market for securitisation also precluded opportunities for banks to generate loans without exercising due diligence. RBI maintains strict controls on sectoral exposures, especially on lending to the volatile real estate sector.

Regulatory authorities have been cautious in allowing development of speculative markets that could undermine financial stability.

The fragmented state of Indian banking, or rather the absence of very large banks, resulted in a situation where most banks lacked the resources to enter into complex derivative transactions in international markets. The lack of commensurate expertise in international operations induced banks to focus primarily on domestic operations. Thus the smaller average size of Indian banks (relative to banks in China for instance) limited opportunities for engaging in risky transactions in international markets.

RBI has been pursuing a pre-emptive counter-cyclical monetary policy which helped mitigate the effects of the business cycle. This has translated into raising risk weights and tightening the provisions against loans to sectors with rapid credit growth, thereby pre-empting mispricing of risk. This has been true of lending to the real estate sector, and investments in mutual funds by banks. Monetary policy has also been well supported by macro-prudential measures.

An important lesson from the subprime crisis is that the national regulatory structures had a much stronger impact in mitigating the effects of the crisis than a bank's governance structure. Banks with international operations, especially those in the private sector were affected more by the crisis on account of their investments in mortgage derivatives, reflecting an inability on the part of a bank's governance structure to rein in risky investments.

Lessons to be learned from the subprime crisis

The crisis has revealed systemic failures in risk governance, in regulatory oversight and in the design of risk management systems and compensation systems for executives in the financial sector. "Risk management systems failed in many cases due to corporate governance procedures rather than the inadequacy of computer models alone: information about exposures in a number of cases did not reach the board or even senior levels of management, while risk management was often activity rather than enterprise-based" (Kirkpatrick, 2009, p. 2).

Shortcomings in regulation

An analysis of the gaps in regulatory oversight, and more importantly of the scope and design of regulation is central to an understanding of the causes of the crisis. The multiplicity of regulatory authorities complicated issues of jurisdiction in the United States. Conversely, in the UK the single regulator—the Financial Services Authority—didn't fare much better in identifying latent risks. Managing market developments—including the identification of risks associated with the widespread diffusion of derivative products based on subprime mortgages—seemed beyond the capabilities of the regulatory authorities. Existing risk management models or the models seeking to capture macroeconomic risks were unable to endogenise systemic risk or liquidity risk.

In an environment characterised by a surfeit of liquidity, an extended bull market run, low interest rates, and a search for returns by investors, asset prices underpriced risk, leading to positions that were much riskier than warranted by market conditions. In the United States, neither the Federal Reserve in the case of commercial banks, nor the Securities Exchange Commission (SEC), in the case of rating agencies and investment banks and brokerage houses, were able to effectively identify, let alone monitor, risk taking. The absence of a clear division of responsibilities across the different authorities allowed market players to generate and repackage risky products, and off load them from the balance sheet. The conduct of credit rating agencies in the years prior to the crisis revealed serious conflicts of interest. The extremely lax standards in rating structured products are well documented (BIS, 2008; SEC, 2008). The models deployed by rating agencies were deemed flawed, and the ratings business was often subject to severe conflicts of interest leading to inflated ratings for highly risky securities. The absence of clear accounting standards and disclosure for off balance sheet products complicated the challenge for market participants to establish fair value for traded products.

Corporate governance

The unique nature of banking necessitates a broader role for the board of directors. The mandate for a bank's board of directors should

include the review and guidance of corporate strategy; risk management, including the establishment of systems of controls; the guarantee of the integrity of the corporation's accounting and reporting systems; and the alignment of key remuneration with the long term interests of the company and its shareholders. Each of these objectives has a bearing on the risk management function.

The boards of directors of banks lacked the expertise and information necessary to guide bank behaviour. Bank boards were generally unaware of the implications of the growth of a shadow banking system. A sustained flow of profits from new mortgages without an observable change in the bank's risk profile helped sustain an air of complacency. Few boards were active in guiding or monitoring the development of a business model. In the larger money centred banks, the trading desks took on risks without adequate guidance from the board, often without a clear mandate, and seldom with input from the risk management department.

Risk management

At a broader level, research conducted by multilateral agencies and supervisory groups into the causes of the crisis uncovered several fault lines. The risk management function was often delegated to the back office through the growth period of the nineties and the early part of the current decade when bank earnings rose steadily. The function was decentralised without clear lines of communication across divisions, e.g. between commercial banking and the trading desk, or between commercial and investment banking in the same bank. The outcome was a compartmentalised approach to risk management with divisions focusing exclusively on risks germane to their own departments. Boards were remiss in creating an environment that would facilitate a broader perspective on risk management within the organisation. Financial firms persisted with a compartmentalised "silo" approach to risk management, neglecting the linkages between different risks. As a result, credit risk was assessed independent of operational risk. Market risk would need to be assessed at the institution level, while default risk would be the mandate for individual divisions. Underlying this was the prevailing culture wherein risk management was deemed important

only during periods of volatility. In a bullish market the pursuit of profits pushed cautionary voices to the background, with risk managers lacking the authority or voice to effectively communicate their concerns within the organisation. Risk managers seldom had access to the top management, let alone an effective voice in setting direction or placing constraints on risk strategies.

The silo approach also resulted in an over reliance on purely quantitative models based on a restricted set of assumptions. These models drew on the historical behaviour of asset prices and volatility indices, which resulted in the inability to spot outliers or "black swan" events. The prevailing focus on purely quantitative models continued in the absence of oversight of the risk management function at the board level. Structural changes in the financial system, such as the expanding flow of funds across national boundaries and between financial institutions and financial markets through securitisation, and the growth of the fund management industry warrant a macro level assessment of newly evolving risks. The problems were compound by the compartmentalised approach that prevailed in most financial institutions and the absence of guidelines or direction by regulatory authorities who were best placed to identify evolving systemic risk. Regulatory authorities and risk managers were unable to identify systemic liquidity problems that could crop up in the event of rising defaults. The fact that risk management systems failed in some of the most sophisticated financial institutions reflects failures in governance as well as oversight of the risk management function itself.

While enterprise risk management (ERM) has been a widely advocated approach to risk management, few banks have actually implemented it. ERM requires an explicit statement of objectives, and more crucially mechanisms for information dissemination and risk assessment that would facilitate identification of different risks, and create the ability to consolidate and identify the interaction between different types of risks.

Inadequate disclosure

Within banks, the transmission of information on risk has been poor. A survey of risk management practices at banks conducted by the consulting

firm KPMG (2008) revealed that many banks were lax in establishing a clear protocol for reporting the consolidated risk positions for the bank. The Senior Supervisor Group's Report (2009) revealed serious shortcomings in the identification of exposure to derivative securities. Bank's boards had limited understanding of the dynamics of growth of the bank's balance sheets and the associated risks and liquidity needs. Few boards seem to have taken note of the warnings on a build up of systemic risk that were documented in reports by the Financial Stability Forum (2008), Financial Services Authority (2009), the Bank of England's Financial Stability Report (2009), and in various BIS publications.

The complex nature of bank transactions and the business model followed by the larger money-centred banks complicated the collation of information across the firm, especially an assessment of latent risks. The fragmentation of risk functions across divisional lines also prevented an assessment of the overall risk parameters in the firm.

Proactive risk managers often found it difficult to articulate their concerns and to convince senior management and the board of disquieting results revealed by stress tests and associated scenario analyses. This was a reflection of the broader attitude at large banks—generating profits was the primary objective, and banks found strength in numbers as long as other banks were taking on similar risks.

Alignment of remuneration with bank's longer term interests

The most serious governance shortcoming to emerge from the crisis has arguably been the inability to align a bank's long term interests with the senior management's remuneration packages. Compensation packages created incentives for risk-taking whereby management would benefit in the event of favourable outcomes, while shareholders, and in the worst case scenario the taxpayer, bore the losses.

Incentives are distorted not only at the senior management level but also at the trading desks. Financial targets are seldom measured against underlying risk, thus underestimating and endangering bank capital. Basel II was intended to remedy this to some extent; however it may have

compounded the problem by allowing banks to use their own risk models to calibrate the level of capital they were required to hold. As was evident from the crisis, the internal risk models significantly underestimated the risk exposure of their positions. The Basel accord ignored aggregate leverage ratios, a simple yet, in hindsight, effective measure of overall risk.

The problem is compounded by the short-term nature of incentive structures, especially those designed for the trading desks and structured products. The high proportion of variable pay, e.g. as bonuses, relative to fixed pay, creates incentives for short –term high risk strategies. Managers are rewarded for taking ‘alpha’ (non-systematic) risks (Rajan, 2008). For instance, by repackaging securities and counting on continuing low interest rates, bankers were able to generate high returns. This strategy however entailed ignoring hidden tail risks, which could, and indeed did, result in highly negative returns.

Why India should not be complacent

Areas of vulnerability

As noted earlier, the subprime crisis had a relatively limited impact on the Indian economy. This was partly due to RBI’s sound and prudent policies, and in part due to the conservative nature of Indian banking. However as the economy continues on the trajectory of deregulation and greater integration with the global economy, a number of challenges are likely to emerge. The subprime crisis is certainly not the last financial crisis to occur. Vulnerability to changes elsewhere in the global economy is only likely to be heightened in the near future as financial markets become more integrated, enhancing vulnerability to external shocks and to greater competition and financial innovation within the economy. There is much that can be learned from the experience of other countries during the subprime crisis as well as from the past experience of economies at a level of development similar to where India is today.

As the economy and the financial sector grow, banking in India will experience major structural changes. Banks will encounter new kinds of

risks—structural, geographic, counter-party, etc. Basel II places a great deal of emphasis on internal monitoring. For this to work, substantially improved disclosure and capabilities to assess risk are imperative. The new private sector banks are on a rapid growth trajectory, which is likely to accelerate not only through organic growth, but also through domestic and overseas acquisitions.

Banks are likely to expand operations overseas, with greater diversity in portfolio holdings, a rise in the share of fee income, and greater use of derivatives. Deepening links with capital markets, especially through securitisation and increasing bank investments in mutual funds will enhance the volume and volatility of the movement of funds between banks and financial markets. As capital markets develop and banks turn to off-balance sheet activities and fund management, trading activities will assume greater importance. This adds to the riskiness of bank portfolios.

With firms raising funds through new channels and in overseas markets, there will be a commensurate increase in risks. The trend towards disintermediation and growing portfolios of non-bank financial companies (NBFC) will raise systemic risk in the financial system. Bank management as well as bank's board of directors need to be at the forefront of these changes.

The emphasis on financial inclusion results in a need for innovative financing methods and processes. This may inevitably call for greater volume of lending to 'subprime' borrowers, and some form of securitisation—at the very least, increased interaction with financial markets.

Sustained real sector growth will lead to greater competition for funds, narrower interest margins, and increased recourse to short-term funding. These structural changes are likely to result in tighter margins and a trend towards riskier positions and increased leverage. Periods of growth in emerging market economies are also accompanied by rapid increases in asset prices in equity markets and the real estate sector, increased leverage ratios, recourse to short-term funds, increased lending to high growth

sectors characterised by high leverage ratios, all of which add to financial fragility.

As with other industries, the banking sector in particular suffers from a paucity of skills at the level of the board. The trend towards increasing liability on the part of directors for acts of malfeasance has led to an inherent reluctance on the part of many qualified professionals to join bank boards.

The next section attempts to collate the experiences of other economies during the subprime crisis in order to glean some insights for an emerging market economy, such as India.

Measures required for securing a stable future

As observed earlier, the level of integration with the global economy, especially in the domain of finance, is only likely to grow in the future. This will inevitably increase exposure and vulnerability to trends in global financial markets. The subprime crisis provided a useful wake-up call and an opportunity to plan for the future. There are several sources of vulnerability that need to be addressed—the role of other market monitors, including credit rating agencies, investor associations, the regulatory agencies, minority investors, depositors and outside shareholders are some of them. The first unequivocal lesson from the subprime crisis (and other past financial crises) is that regulation is an essential concomitant of corporate governance, and effective governance per se is integral to maintaining an efficient stable financial system. Table 3 provides a synopsis of proposed reforms and initiatives that could be meaningful for India in the years ahead.

Table 3: Charter for risk governance initiatives

	Regulators (Reserve Bank of India; SEBI, MCA)	**Corporate Governance**
Risk governance	• Address weaknesses in Pillars I & III of Basel Accord • Demarcate role and responsibilities of board in establishing risk targets and monitoring mechanisms • Prescribe guidelines • Grant explicit authority to CRO for overseeing risk and reporting and participating in board meetings	• Clearly assign of responsibilities for risk management across the organisation • Ensure clear understanding on part of boards regarding their role in establishing risk targets and risk management strategies
Risk management	• Articulate and adapt Basle II provisions based on experiences with subprime crisis • Establish independent board monitoring systemic risk • Establish framework for monitoring systemic liquidity risk • Prescribe risk management guidelines • Ensure that CRO reports to the board and is an active participant in board meetings; reportage on risk to be made part of mandatory guidelines	• Mechanisms for implementing Enterprise Risk Management approach • Risk management organisational silos (focusing on specific risks such as credit, market, liquidity risk etc.) to coordinate and synthesise their activities so as to encompass all lines of business and linkages therein • Risk management should be a front office function • Senior management (with board input and approval) to set the direction and articulate the firm's risk appetite • Roles and responsibilities to be articulated in written policies.
Compensation and oversight of remuneration packages	• Prescribe detailed guidelines for compensation aligning managerial incentives with long-term interests	• Oversee design of compensation packages, including split between fixed and variable components. • Monitor indirect compensation that aims to avoid direct controls • Ensure incentive structures at trading and sales desk are aligned with longer-term interests of bank
Disclosure	• Prescribe disclosure guidelines • Mandate, monitor and enforce disclosure • Embed special provisions relevant to financial institutions disclosure requirements in Clause 49 • Prescribe guidelines for financial and nonfinancial disclosure • Ensure adherence to international accounting standards	• Oversee implementation of disclosure guidelines • Develop comprehensive statement on governance

	Regulators (Reserve Bank of India; SEBI, MCA)	**Corporate Governance**
Role of board of directors	• Professional certification for directors • Separate position of Chairman and CEO • Independence of boards to be guaranteed • Board to clarify and formalise its risk management oversight role • CRO to have both implied and explicit authority and visibility for risk management. • Corporate risk committee to include finance professionals and business leaders • Risk management to be made an integral part of front office and deal-approval committees	• Activist boards demanding and obtaining holistic view of on and off balance sheet risks, and risk management strategies • Risk management division to actively participate in business and strategy discussions • Risk management division to seek guidance from and have access to the board in order to understand their objectives and perspective • Risk management division to receive guidance from the board in its oversight role

Regulation

The Reserve Bank of India, often charged with being too conservative found itself vindicated in the aftermath of the subprime crisis. Higher capital requirements, stringent portfolio restrictions, limits on securitisation, and high interest rates effectively checked many of the policies that laid the foundations of the subprime crisis.

RBI has gradually changed its regulatory approach from a one-size-fits-all to a risk-focused supervisory approach. This is a paradigm change as banks are being given greater autonomy to pursue fresh avenues of business and diversify their investment portfolio. This change puts a greater responsibility on banks to monitor their operations as earning and risk taking opportunities increase manifold. This change would also entail allowing greater leeway to market forces. Markets work efficiently if there is clarity in the information provided by the participants. Banks need to bolster their disclosure and governance standards and effectively manage their increased risk exposure. Increasing volatility and vulnerability in financial markets has reinforced the need for greater disclosure and timely and accurate monitoring of bank portfolios.

There is a need for a fundamental rethinking of the Basel II Accord. Pillar 1 which specified capital requirements following the internal rating based models developed by the banks themselves failed in its task of safeguarding bank capital. The market was unable to monitor, let alone discipline, banks that were taking on significant risks. The opaqueness of a bank's balance sheets complicates the external monitoring outlined in Pillar 3 of the Basel Accord. Drawing upon its legacy of effective stewardship of the economy over the past two decades, RBI could establish regulatory and supervisory guidelines that would help embed risk metrics in disclosure. The bottom line is the need for proactive regulation that ensures accurate and timely disclosure and provides external stakeholders with the resources to effectively monitor banks.

The crisis has reinforced the need for raising regulatory standards for governance and risk management. RBI could consider prescribing guidelines and standards for strengthening the role of the board of directors, and could create a framework for inducting proactive independent directors with experience in the financial industry, especially in risk management.

Corporate governance

As discussed earlier, corporate governance of banks is intrinsically challenging. Given the complicated and opaque nature of the business, bank governance requires specialised skills. Risk is easily diffused or transferred through trading activities, or through off balance sheet transactions. There is a serious global paucity of personnel who are qualified to be directors and are well versed in risk management. While India has a surfeit of talent in commercial and investment banking, risk management skills amongst senior management are limited. There is clearly a need for specialised training. The Institute of International Finance (IIF) and other agencies have proposed the need for skills certification courses for board members.

Compared to other emerging market economies, India has a sizable pool of skilled bankers. However in a highly regulated environment, there has not been a commensurate development in risk management skills. The institutional infrastructure for development and execution of risk

management from within the firm is lacking. Risk management systems in the smaller state-owned banks and the older private sector banks remain outdated, with banks generally lacking personnel with the necessary skills. These banks also lack clearly articulated pro-active risk management frameworks.

The crisis has underlined a pressing need for fundamental changes in governance and risk management at banks. Like banks in most other economies, Indian banks have followed a silo like approach to risk management with a division focusing exclusively on credit risk or operational risk. The inextricable links between regulation and corporate governance and the rise of risks outside the banking system make it necessary for boards to ensure that regulatory norms are met, and the bank's risk management division is aware of the broader macroeconomic and systemic risk. For this to materialize, close coordination with the regulatory and supervisory authorities and a clear understanding of governance norms on the part of the board of directors is essential.

The board of directors should adopt a firm-wide focus on risk. Recent events have underscored the need for risk consciousness to permeate the bank. For this to be meaningful it is imperative that senior management (including the CEO) assume direct responsibility for risk management. At the operational level this would entail clarification of each division's role and responsibility, and the mechanisms for coordinating risk throughout the organisation. The compliance division must have access to senior management to be able to articulate concerns in a timely manner.

A recent development aimed at lending clarity to a bank's risk profile is an effort to articulate the institution's risk appetite, which would ensure that risk parameters are defined throughout the bank. The risk management department should accordingly define basic goals and strategy, and monitor performance over time. The definition of risk appetite should encompass all types of risk, including those arising from off balance sheet activities.

Role of the Chief Risk Officer

Risk management has traditionally been treated as a back office function, with the Chief Risk Officer (CRO) generally assuming an

advisory role. The CRO seldom has a voice in the board room. In the current environment it has become imperative to guarantee independence and adequate funding for the risk management and auditing functions. The CRO needs to have direct access to the board, instead of communicating through functional heads. The CRO should be a senior member of the bank's staff with direct access to the board with independence from line business management, in order to have a meaningful impact on decision-making. The development of the shadow banking system points towards the need for expanding the scope of a CRO's jurisdiction to encompass control, management and oversight functions, as well as scrutiny of new product development, in addition to the traditional responsibilities of monitoring vulnerability to credit risk, credit concentrations, maturity mismatches and high leverage ratios.

Remuneration packages and incentive structures

It is essential for the board to oversee the balance between risk-taking and the longer term interests of stakeholders. Central to this is the oversight of incentive structures determining compensation systems. The board should have the expertise to define the firm's policy towards risk tolerance and to determine risk parameters over time, with periodic reviews. The bank's business model needs to be explicitly stated and monitored to facilitate the board's oversight functions.

The distorted incentive structures resulted in the remuneration systems leading to short-term high risk strategies by bankers oriented towards yielding high returns, have come under a great deal of scrutiny. The cumulative effect has been to render a bank's balance sheet positions unsustainable, and vulnerable to macroeconomic shocks. Incentive structures at the trading and sales desk have also served to enhance excessive risk-taking behaviour. The inability to measure the risk in such a situation makes it impossible to calibrate the risk adjusted cost of capital—an assumption underlying the Basel Accord.

Governance practices across Indian firms

A recent survey by the Associated Chambers of Commerce and Industry of India revealed rapid growth in the volume of non-performing

assets (NPAs) held by Indian banks. On a year-to-year basis, net NPAs rose by nearly 35%. Recovery of these NPAs is crucial to the future stability of the banking system. RBI has taken pre-emptive action by establishing asset reconstruction firms; however these entities have been slow in getting off the ground. They are also crippled by the extremely slow pace of the legal system.

Corporate governance standards in India still remain weak by international standards, though there is marked heterogeneity across firms. As mentioned earlier, the onus of governance remains with the regulatory agency. Nevertheless bank boards can and, in many cases do, perform a vital role in ensuring effective governance and risk management. Indian banks are lacking in this regard.

State-owned banks account for approximately 70% of the total assets of the banking sector. The boards of these banks consist primarily of bureaucrats and other government nominees. These banks have exercised prudence in lending. Mandated priority sector lending and increasing competition with the new private sector banks and foreign banks are likely to affect their growth prospects and competitiveness. These boards are known to favour prudential policies, which was appropriate during the period when state-owned banks constituted a de facto monopoly. However in an era of increasing globalisation, proactive policies need to be factored in so as to avail of new lending and investment opportunities.

The need for improved disclosure and corporate governance is only likely to increase in the future as financial liberalisation continues. Lowering the cash reserve ratio and statutory liquidity ratio — essential if Indian banks are to enhance their competitiveness and lending within the domestic economy—will also allow for increased leverage and risk-taking. This makes improvement in governance standards imperative.

Further deregulation of interest rates is also essential for enhancing the competitiveness of banks vis-à-vis non-bank financial companies. Banks have deployed excess liquidity to lend to NBFCs and have placed funds in debt-oriented mutual funds. The movement of funds into these channels reduces the effectiveness of RBI's regulatory oversight.

While a number of official studies and committees have delved into the challenges associated with effective corporate governance in India, there has been limited discussion on the idiosyncrasies and special challenges related to the governance of banks. The government committees established to examine issues of governance (Kumara Mangalam Birla Committee, 1999; Narayana Murthy Committee, 2003; J. J. Irani Committee, 2004) have focused on traditional issues such as the composition of the board, the role of independent directors, etc. with little attention paid to specific issues related to governance of financial institutions, and even less to links between governance and risk management.

The Confederation of Indian Industries (CII) produced one of the earliest codes of best practices in corporate governance in the region in 1998. The India code of Corporate Governance was approved by the Securities Exchange Board of India (SEBI) in 2000. It led to changes in listing rules in the stock exchange, most significantly in the newly formulated Clause 49.

Clause 49 has been a notable development in the evolution of corporate governance in India. Clause 49 of the Listing Agreement enunciated by SEBI spells out the governance code for listed firms, with a special focus on the role of directors at banks. It is mandatory for corporates to comply with its provisions. It also attempts to induce banks to articulate their risk management framework, and raise awareness among all relevant employees of the bank. This clause provides a clear link between risk management and governance in financial institutions, and stipulates disclosure requirements, characteristics and composition of the board of directors, the role of the Chairman and the CEO. Clause 49 also requires management to report to the board on risk of positions and risk management strategies. The Institute of Chartered Accountants of India (ICAI), an independent body regulating the accounting and auditing profession in India has initiated revisions in India's accounting standards to ensure compatibility with International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS).

SEBI has been proactive in revising Clause 49 to ensure it incorporates global best practices and to meet the needs of an evolving market. The clause has been revised to include many of the norms prescribed in the Sarbanes-Oxley Act (2002), including issues related to independence and composition of the board of directors and the audit committee, disclosure requirements, compliance reports, reportage on corporate governance, and penalties in the event of non-compliance of certain requirements.

ICAI recently approved the Accounting Standard 32 (AS 32), addressing "disclosure of losses and gains from investment in market-linked instruments such as derivatives, futures and options, mutual funds and government securities." This is meant to bring about greater transparency in the institution's investment activities. Apart from facilitating improved risk management, it will provide vital information to outside monitors. These changes in accounting standards will help investors assess the entities risk exposure, and incentivise firms to place more stress on risk management practices. The norms are based on international accounting standards and will require firms to mark to market.

SEBI has played a crucial role in improving corporate governance in enterprises. Its policy reform has focused on important issues like the qualifications of directors, disclosure guidelines, the role and scope of audit committees, etc. However it says little on issues of risk oversight, even though in recent industry surveys (KPMG, 2009) an overwhelming proportion of respondents point towards inadequate risk management oversight as a major constraint on effective corporate governance.

6. Conclusion

The current environment in which India has escaped the worst of the crisis and banks are well capitalised is the ideal situation for launching the next generation of financial reforms, and equally importantly, for strengthening the regulatory environment and risk management regime. Time and again crises in financial systems in emerging market economies have derailed growth, plunging economies into crises. The causes have

been remarkably similar over time—high degrees of leverage, rapid growth of investments in financial assets and the real estate sector leading to asset price bubbles, and neglect of prudential supervision norms and risk management during growth periods.

Research on the crisis has yielded some clear findings. Economies that were better regulated fared better; within economies, banks with superior risk governance fared better than other banks. These are simple, obvious, and meaningful insights and they offer useful pointers for India as it continues on the path to growth. The Reserve Bank of India, building upon it impressive track record, can depart from convention and strengthen the foundations of the financial sector now. It is well over a decade since the last significant set of reforms was implemented following the first Narasimhan committee report (1998). Apart from further deregulation of interest rates, this would include the lowering of cash reserve ratio (CRR) and the statutory liquidity ratio (SLR) to release capital locked up in low yield government bonds. Coupled with interest rate deregulation, this could help banks lower interest costs as they channel funds into higher yield investments. More importantly, the crisis has highlighted the importance of sound risk governance.

Lest regulatory authorities and market observers be caught up in hubris, there are grounds for caution in the existing scenario as well as upon reflections on past crises. The proportion of non-performing assets has been growing in recent years and poses a serious threat to bank earnings, and if left unaddressed, to bank stability. With financial innovations and a sustained increase in trading and off balance sheet activities, new kinds of liquidity risks and systemic risk will enhance susceptibility to changes in market conditions. The growth of trading activities in the larger banks generates income earning opportunities for banks, but it also enhances vulnerability to changes in interest rates, and sudden shifts in asset prices. Stephanou's (2010) review of experiences during the crisis reiterates the importance of good governance for providing incentives for bank 'insiders' to exercise appropriate oversight, and to disclose adequate,

timely and reliable information on performance and risk exposure. This is vital if market discipline is to work more effectively than it has over the past decade.

The Reserve Bank of India's internal assessment of conformity to the Basel II principles points towards a number of shortcomings in risk governance (Table 4). These range from the risk management process in banks (deemed 'materially non-compliant), managing risk of exposure to third parties, market risk, and liquidity risk to the lack of a clearly articulated home-host cross-border bank supervision policy. The wide heterogeneity in investment portfolios, skills base and risk profile among Indian banks, creates a compelling case for continuing with close regulation of banks that are not fully equipped to deal with risks, and to a continued shift towards risk-based supervision of banks further along the learning curve. It is encouraging that state owned banks that have issued equity demonstrate improved disclosure and better governance.

There are some characteristics that may be idiosyncratic, but as we move towards a more integrated and globalised financial system, it is worth bearing in mind that the risks encountered by banks across the globe are the same. However domestic regulation can play a significant role in guiding a bank's behaviour, and thereby the level of risk encountered by individual banks as well as the financial system as a whole. The relative insulation of Indian banks from the worst effects of the crisis was partly the outcome of fortuitous circumstances, partly due to prudence, and in part due to regulations that prevented excessive risk taking behaviour.

Table 4: RBI's assessment of conformity to the core Basel principles

Sr. No.	Principle	Status of compliance
	Objectives, autonomy and i-esources	
1.	Objective & independence, powers, transparency'and co-operation	LC
	Licensing criteria	
2.	Permissible activities	C
3.	Licensing criteria	C
4.	Transfer of significant ownership	C
5.	Major acquisitions	C
	Prudential requirements and risk management	
6.	Capital adequacy	C
7.	Risk management process	MNC
8.	Credit risk	LC
9.	Problem assets, provisions and reserves	LC
10.	Ijrge exposure limits	C
11.	Exposure to related parties	MNC
12.	Country and transfer risk	C
13.	Market, risk	MNC
14.	Liquidity risk	MNC
15.	Operational risk	LC
16.	Interest rate risk in banking book	NC
17.	Internal control and audit	LC
18.	Abuse- of financial Services Methods of ongoing supervision	LC
19.	Supervisory approach	MNC
20.	Supervisory techniques	LC
21.	Supervisory reporting Accounting and disclosure	LC
22.	Accounting and disclosure Corrective and remedial powers	LC
23.	Corrective and remedial powers of supervisors Consolidated supervision and cross-border banking	LC
24.	Consolidated supervision	LC
25.	Home-host relationship	MNC

C: Complaint; LC: Largely Complaint; MNC: Materially Non-Complaint; NC: Non-Complaint; NA: Not Applicable.

Source: RBI (2009)

Risk management systems were clearly ill-equipped to identify let alone monitor and manage risks. There is a profound need for a paradigm

change in risk management and governance. The regulatory authorities need to be deeply involved in the basic task and challenge of identifying risks at the economy wide level that are beyond the purview of individual banks.

A wide range of innovative products and processes and the emergence of a shadow banking system have resulted in risk being easily transferred beyond the individual bank—through repackaging of loans, or through trading activities. Monitoring of risks necessitates looking beyond the bank, often at the financial system as whole and at cross-border financial linkages. Capital account convertibility has de facto increased volatility and posed serious challenges. This calls for a radical redefinition of bank governance, with a need to redefine the scope of governance to encompass the implementation of regulatory directives.

Bank governance in itself is complex issue— in emerging market economies governance of risk management falls below the radar, and seldom receives attention beyond platitudes on the importance of the risk management process in banks. Existing risk management and governance systems have proven to be inadequate in an increasingly globalised, sophisticated financial system with blurred boundaries between financial institutions and markets. The crisis graphically pointed out the inadequacies of bank governance structures in ensuring that the interests of the stakeholders were defended, and that management worked in the best interests of the various stakeholders.

Weak oversight and monitoring mechanisms are considered the main obstacles to sound governance. Experience over the past two years has underlined the need for regulation with mechanisms to ensure compliance with regulatory norms and supervisory principles, complemented by principles-based standards—the basic building block for a resilient financial system. The Indian banking system weathered the crisis with minimal damage, it is now time to capitalize on its latent strengths to carry the economy through the next generation of reforms.

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Notes

[1] This section draws upon IIF (2008) and the G30 Report (2009).

9

Ownership and Corporate Governance in Indian Firms

Jayati Sarkar*

1. Introduction

The nature of the corporate governance problems in corporations is largely dependent on their ownership and control structures, and the institutional set-up in which such corporations are embedded. At the same time, the ownership structure is one of the key internal governance mechanisms widely considered to mitigate governance problems both in widely-held firms and in those with concentrated ownership and control. The objective of this paper is to examine first the ownership structure of listed private sector Indian corporates as a source of potential governance problems,[1] and then to analyse how such problems can be alleviated by different ownership constituents. Additionally, based on existing empirical studies in the Indian context, the paper seeks to review the existing evidence on the link between ownership and corporate governance as manifested in firm performance. The importance of analysing the ownership structure of Indian corporates and its link to performance is underscored by the fact

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that the onus of several high profile corporate scandals both in India and abroad has been placed on underlying ownership and control structures.

The examination of the ownership structure of Indian listed private sector companies in this paper is based on relevant data available from the mandatory disclosure under Clause 35 of the Listing Agreement. Given the periodic changes in disclosure requirements with respect to major equity owners, the analysis of the ownership structure in this paper will be mostly based on comparable data available at a stretch since major changes were instituted in 2000–2001. Given that the ownership data prior to 2000–2001 was in a significantly different format than the data since 2000–2001, the data analysis will be primarily based on data post 2000–2001. Here also, depending on the comparability of the data, some analysis will focus on data up to 2005–2006, while some will extend to 2007–2008 (the latest year for which comprehensive ownership data is available at the time of writing). The analysis will be based on listed private sector companies in India, and both ownership and financial data will be sourced from Prowess, the computerised database on Indian companies published by the Centre for Monitoring Indian Economy (CMIE).

The rest of the paper is organised as follows. Section 2 briefly presents the theoretical background from an agency cost perspective of how the governance problem is manifested in ownership structures of corporations, on the one hand, and how ownership structures can serve as internal governance mechanisms to alleviate governance problems on the other. Section 3 discusses the characteristics of the ownership data with respect to listed Indian corporates. Section 4 analyses how agency problems in listed corporations are in-built in ownership structures specifically in the Indian context, while Section 5 focuses on how the important ownership constituents, namely promoters, banks and financial institutions, and institutional investors, play a role in the governance of corporates. This section also includes a review of the existing empirical literature examining the link between ownership structure and corporate governance with respect to Indian listed companies. Section 6 presents and examines select evidence with respect to minority shareholder expropriation in Indian listed companies. Section 7 concludes the paper.

2. Ownership and the problem of governance: Theoretical background

Ownership structure as a source of governance problem

While there are several alternative theoretical perspectives on the corporate governance problem that span across different disciplines, the dominant theoretical paradigm of corporate governance in economics and finance is the agency perspective, also known as the corporate finance perspective. Under this perspective, corporate governance deals with the ways in which the suppliers of finance to corporations exercise control and ensure accountability of company management in order to ensure they get the best possible return on their investment (Shleifer & Vishny, 1997). The foundations of this perspective can be traced back to the agency problem highlighted by Berle and Means (1932) in their pioneering work in the context of US corporations with dispersed share ownership, where shareholders (the principal) provide funds to managers (the agent) to put them to productive use and generate returns for the principal. Given such a separation of ownership and control, agency problems between the shareholders and managers can arise when due to either asymmetric information (managers being better informed about company performance and prospects) or unobservable efforts of the managers (moral hazard), the managers are able to take self-serving actions (such as appropriating funds for over consumption of perquisites, empire building) at the expense of the dispersed shareholders. Under such circumstances, Berle and Means (1932) raise the question of whether "social and legal pressures should be applied in an effort to insure corporate operation primarily in the interests of the 'owners' or whether such pressure shall be applied in the interests of some other or wider group" (p. 173). Corporate governance becomes meaningful in such a context, in terms of a set of mechanisms—both internal and external to the firm—that seeks to limit managerial discretion, or that provide incentives to help align the interests of managers with those of the shareholders. The relevance of such mechanisms from the corporate finance perspective lies in the fact that without such mechanisms, investors may be unwilling to provide low cost external financing to firms, the availability of which is critical for investment and growth.

While corporations with separation of ownership and control have dominated the US and the UK, cross-country studies have shown that there is a significant concentration of ownership both in developed countries (including the US and the UK) and in developing countries (La Porta et al., 1998). In Asian economies including India, concentrated ownership and control is the rule rather than the exception. Under concentrated ownership and control, the nature of the agency problem is essentially different from that present in diffuse ownership structures. While in the latter, agency problems arise on account of shareholder manager conflicts, dubbed in the literature as Type I or vertical agency problems, in the former, agency problems arise primarily due to conflicts between the two categories of principals—the controlling inside shareholders and dispersed minority outside shareholders, dubbed as Type II or horizontal agency problems (Roe, 2004). Type I agency problems are likely to be alleviated under concentrated ownership and control as the incentives of controlling shareholders to monitor management would be stronger on account of their substantial stakes in the corporation. This, however, does not preclude Type II agency problems, of the incentives of controlling shareholders from seeking to extract and optimise private benefits for themselves at the expense of the minority shareholders (Morck & Yeung, 2004). For instance, owners of business groups in regions such as Asia, Latin America, and Continental Europe, by virtue of owning substantial family ownership, are directly involved in the management of companies in which they have controlling blocks, including as a part of the board of directors. This can give them large discretionary powers over a firm's decisions which can be opportunistically used to expropriate minority investors.

Expropriation by controlling shareholders can be accomplished even under situations where shareholders do not have control through cash flow rights by using structural devices like dual class shares and stock pyramids that enable the creation of control rights far in excess of cash flow rights. For instance, in the case of family-owned business groups with a large number of affiliated firms, the controlling owner of one firm

can extend control over other companies in the group through the use of stock pyramids (Morck & Yeung, 2004). A pyramidal structure is one where a family firm A at the apex of the pyramid has majority ownership in a publicly traded firm B (say 51%), which has majority stakes in another publicly traded firm C (51%), which has majority ownership in a publicly traded firm D (51%), and so on. Given that A has majority control in B, and B has majority control in C, and C has majority control in D, A ends up controlling D, with as little as 13% equity. Thus through such pyramiding, the ultimate owner has successfully driven a wedge between control rights and cash flow rights, with control rights in D as well as other firms lower in the pyramid, far in excess of the cash flow rights. Such a wedge works as a vehicle for the expropriation of minority shareholders by controlling shareholders whereby the latter can—through various means at their disposal (like transfer pricing)—transfer wealth from firms in which cash flow rights are lower, to firms where controlling shareholders have higher cash flow rights (say from firm D to firm A).[2] This phenomenon known as tunnelling is one way in which the expropriation of minority shareholders can take place. Pyramid schemes are widespread in emerging economies. Faccio et al. (2001b) estimate that the 22 largest East Asian business groups controlled 31.2% of all listed corporations in their economies through pyramiding. Given the inherent tendency towards expropriation of minority shareholders by controlling shareholders in corporations with concentrated ownership and control, corporate governance in this context has involved the designing of a set of mechanisms, both internal and external to the firm, which would mitigate such expropriation.

Ownership structure as a mechanism of governance

The role of ownership as a mitigating mechanism for agency problems first came into sharp focus in the context of alleviating Type I agency costs in widely-held firms and the lack of monitoring incentives for diffuse shareholders in such firms. Two solutions to the monitoring problem in widely-held corporations have gained credence in the theoretical literature. The first one (referred to as the "alignment hypothesis" or the "convergence of interest hypothesis") is to offer concentrated ownership

stakes to the company management which would increase the overlap between ownership and control and help to align the interests of managers with those of the dispersed shareholders (Jensen & Meckling, 1976; Morck et al., 1988). The alignment hypothesis is less relevant in firms with concentrated ownership and control where higher shareholding by controlling insiders can automatically help to align their interests with those of outside minority shareholders by strengthening the link between the value of the firm and the wealth of the insiders. In fact, in countries with weak legal and institutional frameworks, concentrated ownership is seen as a panacea for Type I agency problems, and at the same time is viewed as a commitment device that sends signals to outside investors that the controlling insiders will not divert corporate assets or engage in other forms of expropriation (Gomes, 2000; La Porta et al., 1999). The second prescription to ensure efficient monitoring to reduce Type I agency costs focuses on the positive role that outside blockholders with relatively large equity positions can play in reducing agency costs. Known as the "efficient monitoring hypothesis" (Berle & Means, 1932; Pound, 1988), its basic premise is that large outside shareholders in widely-held corporations are likely to be efficient monitors as they have substantial investments at stake, and the voting power to ensure that the investments are not lost (Fama & Jensen, 1983; Jensen & Meckling, 1976), and can alleviate the free rider problem associated with small shareholders (Grossman & Hart, 1980), and are in a stronger position to use the proxy mechanism to discipline inefficient management (Dodd & Warner, 1983). Moreover, blockholders like investing institutions can engage in "relational investing," and the presence of blockholders like institutional investors can be socially beneficial as their interests tend to coincide with the interests of the society at large (Blair, 1995).

Concommitant with the benefits associated with large blockholdings in mitigating agency problems are the non-trivial costs as hypothesised under the entrenchment hypothesis, the conflict of interest hypothesis, and the strategic alignment hypothesis. Under the entrenchment hypothesis in the event of underperformance, insiders (by virtue of higher ownership

and control) can successfully insulate themselves from outside disciplining forces such as from the takeover market or the managerial labour market (Demsetz, 1983; Fama and Jensen, 1983; Stulz, 1988). Under the conflict of interest hypothesis, conflicts may arise between outside blockholders and minority shareholders due to the pursuit of objectives by the former that are at odds with those of the latter. For instance, blockholders such as institutional investors usually hold diversified portfolios and so reducing firm-specific risk through effective monitoring may not be their concern (Blair, 1995).[3] Finally, under the strategic alignment hypothesis, institutional investors who are outside blockholders, and managers who are insiders and often blockholders themselves, can find it mutually advantageous to cooperate and act against the interest of minority shareholders (Denis & McConnell, 2005). Strategic alignment between blockholders and management and mutual self-protection are possibilities particularly when a block-holding institution sells something—a product, debt or financial services—to the company in which it owns substantial stocks (Roe, 1994).

Several of the costs and benefits arising from the presence of large shareholders as highlighted in the studies of developed countries could be equally relevant in the context of developing countries like India. At the same time, some of the institutional specificities of developing countries—such as a less developed capital market, a less active takeover market, the absence of a well developed managerial market, the greater importance of implicit trust-based contracting, and a generic tendency towards insider control—could impact the costs and benefits of large shareholding in these countries in some unique ways, and so mechanically extrapolating the experiences of corporate governance systems in developed countries may not yield the necessary answers (Sarkar & Sarkar, 2000). Khanna and Palepu (2000) also argue that monitoring by large shareholders in developing countries may not be as effective as in developed countries because of the poor availability of information on the performance parameters of firms due to inadequate disclosure norms and weak enforcement, the presence of political connections which make disciplining difficult, and the opaqueness

associated with insider ownership arising due to pyramiding, cross-holdings, and association with a large number of privately-held firms.

3. Ownership structure of Indian firms: Data characteristics

Private sector firms in India can be broadly classified into domestic firms affiliated to business groups, domestic firms that are standalones, and foreign-owned firms. With respect to listed firms,[4] as of 2008, the Prowess database provides information for 1021 firms affiliated to Indian business groups, 2004 standalones, and 130 foreign-owned firms. While the number of standalones is higher, group affiliates have persistently dominated the Indian corporate sector both in terms of its share in total assets/sales, and in terms of market capitalisation. As of March 2008, listed group affiliates accounted for around 72% of the total assets of all listed firms, and only two of the top 20 listed non-financial companies are standalones; the rest are affiliated to business groups.

As is the case elsewhere, the ownership structure for any Indian corporate can be broken down into two major constituents—insiders and outsiders. The definition of insiders depends on the structure of ownership and control in a corporation—in widely held corporations, insiders are the professional managers entrusted with the day to day running of a company, and in corporates with concentrated ownership and control (such as family-owned corporations), insiders are the controlling shareholders. In the Indian context, as per the definition of different types of owners laid down in Clause 35 of the Listing Agreement, insiders are promoters and persons acting in concert (PACs),[5] whereas outside owners are essentially non-promoters who are further divided into institutional non-promoters and non-institutional non-promoters.

Since governance reforms gathered momentum in the late nineties, and with the recognition of the need to "upgrade and harmonise" disclosure standards at par with international best practices and to enable better price discovery in the secondary market (SMAC, 2004), the ownership disclosure requirements under Clause 35 have undergone important changes, one effective from March 2001, one from June 2006, and one

from February 2009. The first among these was the most fundamental, changing the disclosure requirements in three ways—re-categorising the major blockholders into two main groups, namely promoters (insiders) and non-promoters (outsiders); requiring the disclosure of the identity of all shareholders holding more than 1% equity along with their shareholding; and requiring the quarterly reporting of shareholder information instead of the existing annual reporting. Prior to 2001, insider holdings were distributed across several categories, such as under Directors and Relatives (as defined under the Companies Act, 1956), and were also clubbed under Corporate Bodies making it difficult for an outside observer to get an estimation of both the voting rights and the control rights of insiders. The reclassification into promoters and non-promoters in 2001 in the interest of transparency was done on the basis of subsections 11(e) and 11(h) of the Substantial Acquisition and Takeover Act of 1997 of SEBI (SAST, 1997) which defined promoters as persons or entities in *control*.[6] By adopting this definition, the regulations took into account for the first time the indirect control that promoters could exercise on a company by virtue of their holdings in other entities controlled by them, and such indirect control was clubbed under persons acting in concert (PACs). Subsequent to the first round of reforms in Clause 35, the definition of the type of equity owners (especially the term *promoters*) went through further refinements as it was being increasingly realised by regulators that the definition of promoters was "extremely critical for actions, regulations, research and analysis" (SMAC, 2004). Thus from April 2006, the definition of promoters and promoter groups, instead of being based on the SAST 1997, came to be drawn from Clause 40A of the Listing Agreement,[7] with the criteria for identifying promoters and promoter groups and their reporting becoming even more encompassing and detailed.[8] At the same time, the shareholdings of PACs which were separately disclosed between March 2001–2006 have come to be included under the purview of promoter groups.

With regard to non-promoter holdings, any shareholding other than promoters was required to be disclosed under the revised Clause 35 under the heading non-promoters which includes institutional non-promoters

and non-institutional non-promoters. In later revisions (after March 2006), the nomenclature has been changed to Public Shareholdings under which institutions and non-institutions are reported separately and in greater detail. Holdings by government-owned financial institutions, public and private sector commercial banks, government-owned and private sector insurance companies, public and privately-owned mutual funds, foreign institutional investors,[9] venture capital funds, foreign venture capital investors, central and state governments, and others, fall under institutional public shareholdings. Under non-institutional public shareholdings are corporate bodies, individuals,[10] and others.

In addition to the greater clarity in the definition of different ownership groups, the requirement to disclose the identity of all shareholders has created more transparency about the identity of the ultimate owners of a listed company, and has made it possible (to a considerable extent) to trace chains of control among group companies from the disclosed data. Here too the disclosure standards have changed over time towards greater transparency, changing from requiring the disclosure of the identity and shareholding of all owners holding at least 1% of outstanding equity (between 2001–2006), to requiring complete disclosure of the identity and shareholding of *all* entities under Promoter and Promoter Group irrespective of any cut-off level, and of all non-promoters with at least 1% equity holding (post April 2006).

It is important to mention in this context that the disclosure of data on insider promoter ownership based on the concept of control rather than on cash flows is rather unique in India when compared to disclosure practices in many other countries characterised by concentrated ownership. This is important because corporations with concentrated ownership are typically characterised by insiders having control rights in excess of cash flow rights due to pyramiding and cross-holdings, with control being achieved with cash flow rights as less as 20%. Hence the deduction of the extent of insider control based on cash flow figures (especially with respect to the ultimate owner) will underestimate the extent of such control. While Indian data completely discloses all entities that are in control of a particular

company, in many of the existing studies of concentrated ownership and firm performance in other countries, a large component of the analysis consists of the identification of shareholders (particularly insiders) who are in control using information available in the public domain to track down both their direct and indirect equity stakes through 'equity chains', and to define different thresholds in order to define control (see for example, Claessens et al., 2000; Lins, 2003, among others). Such an exercise may not be exhaustive due to the lack of data on all owners, as is recognised in Claessens et al. (2000).[11] In contrast, the mandatory disclosure of both direct and indirect ownership of all (at least 1% till 2006) of controlling owners including PACs, helps to largely eliminate the omission bias that is in-built in many studies.

4. Ownership structure and agency problems in Indian corporations

In light of the theoretical discussion in the earlier sections, this section examines the agency problems in Indian listed companies that could stem from their ownership and control structure. Specifically, the section focuses on two key aspects (from an agency perspective)—the prevalence of concentrated ownership and insider control, and the extent of complexity and opacity of ownership structures.

The prevalence of concentrated ownership and insider control

The Indian corporate sector is composed of both widely-held firms akin to those dominant in the US and the UK, as well as firms with concentrated ownership and control similar to those dominating most developing and emerging economies. Based on the definition of widely-held firms as firms where *no shareholder controls 20% votes*,[12] an examination of the ownership structure of 2075 private sector listed Indian firms as of March 2006, reveals that only a small minority of companies in the sample—7.2%—are widely-held, and the remaining firms (irrespective of their ownership affiliation) are characterised by concentrated ownership and insider control. The percentage of widely held firms in India is substantially lower not only with comparable estimates in countries such

as the UK, the US, and Japan which are dominated by such firms, but is also mostly lower than comparable estimates in countries in Europe and East Asia that are dominated by concentrated ownership structures.[13]

The pervasiveness of insider control in Indian firms is revealed in an examination of the ownership structure of 3155 domestic private sector listed firms in India using the shareholding data disclosed under Clause 35 as reported in Prowess for the financial year 2007–2008 (as shown in Table 1). Irrespective of the type of ownership affiliation, holdings by promoters constitute the single largest block (50.15%) for group affiliates, around 46% for standalones, and the highest (62.41%) for foreign firms. Further there are major differences in the constituents of promoter share across ownership groups, with corporate bodies accounting for the highest on average for group affiliates (32.90%), whereas individuals and family members accounted for the highest in the case of standalones (29.68%). In the case of foreign firms, foreign promoter share is predictably the largest constituent within the promoter group.

Table 1: Ownership structure (percentage share) of Indian corporates (2008)

	Group Affiliates	Standalones	Foreign	All
A. Promoter and Promoter Group	50.15	45.98	62.41	48.01
Individuals/ HUF	12.67	29.68	3.30	23.09
Government	0.17	0.06	0.08	0.09
Bodies corporate	32.90	13.31	5.01	19.31
Foreign promoters	3.54	1.94	53.77	4.59
B. Public Shareholdings				
Mutual funds	2.13	1.00	2.70	1.44
Banks and Financial Institutions	3.51	0.97	2.41	1.85
Foreign Institutional Investors	4.71	2.31	3.67	3.14
Corporate Bodies	9.78	11.51	5.09	10.69
Individuals	25.95	34.73	20.16	31.29
Others	3.17	3.11	2.99	3.13
Number of firms	**1021**	**2004**	**130**	**3155**

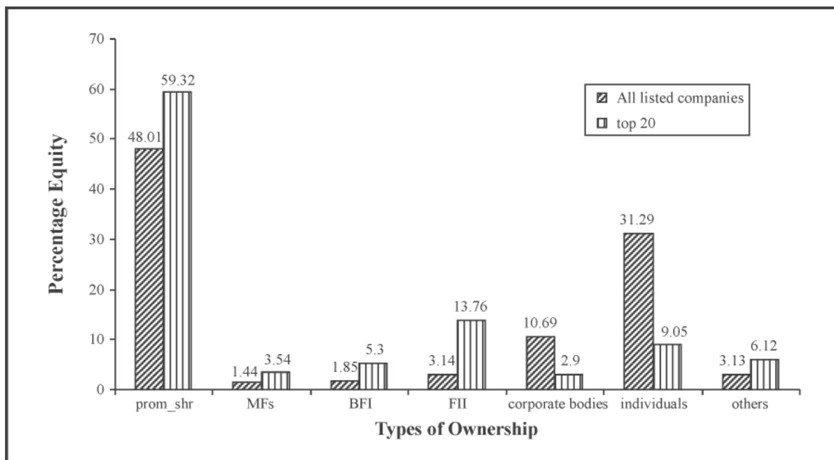
Notes: Constituents under A and B may not add up to A and B respectively due to rounding off errors. Similarly the sum of A and B may not add up to 100%.

Source: Author's calculations based on data obtained from CMIE Prowess database.

Considering outside shareholders, institutional holdings taken together are way lower than insider holdings, accounting for less than 10% on average, with the share of both mutual funds (MFs) and banks and financial institutions (BFIs) being less than 2%, and that for foreign institutional investors (FIIs) around 3% across all sample companies. With respect to non-institutional outside shareholding, holdings by private corporate bodies are around 10%, while holdings by individuals taken together are relatively important at an average of 31.29%, with the highest in the case of standalones and the lowest in the case of foreign companies.

Comparing the average ownership structure of the top 20 non-financial listed private sector companies in the sample ranked by market capitalisation as of March 2008 with the full sample of 3155 firms (Figure 1), we find that the concentration of promoter share on average is substantially higher for the top 20. Further, with respect to institutional ownership, the average holdings by MFs, BFIs, and particularly FIIs are markedly higher for the top 20 firms (as can be expected). Finally, the holdings of the top 20 firms, seventeen of which belong to family business groups, are much less dispersed as measured by the holdings of non-promoter individuals (9%) compared to the larger sample (31%).

Figure 1: Comparison of ownership structure of all listed companies and Top 20 listed companies (March 2008)



Notes: Total number of listed companies is 3155.

Source: Author's calculations based on data obtained from CMIE Prowess database.

Examining the extent and spread of insider control within business groups, an analysis of the distribution of promoter ownership is computed at the group level for the top 10 business groups ranked by total market capitalisation of the listed firms within a group. The relevant summary statistics presented in Table 2 show that on average, the promoter share within a group is substantially concentrated and higher than the average of the full sample in most cases. Even the values of minimum promoter holding in a group are at a higher level than the 20% cut-off that is necessary for gaining control. While there are substantially large differences in the size of group firms both within groups and across groups, the extent of insider ownership and control do not exhibit much difference.

Table 2: The extent of insider control in the top ten Indian business groups (2008)

Name of Business Group	Total Market Capitalisation (Rs. Crore)	Number of Listed Firms	Market Capitalisation (Rs. Crore)			Promoter Share (%)		
			Lowest	Mean	Highest	Lowest	Mean	Highest
Reliance Group	400875.9	4	1384.67	133625.3	329178.73	45.43	68.04	100
Anil Dhirubhai Ambani Group	255466.31	6	2828.23	42577.72	104914.49	35.95	59.67	89.91
Tata Group	237767.64	27	45.5	8806.21	79355.53	27.55	49.76	93.01
Aditya Birla Group	94057.8	8	42.79	13436.83	27078.33	25.19	48.31	70.4
Sterlite Industries Group	73902.52	5	41.1	18475.63	50565.25	38.8	57.96	80
Om Prakash Jindal Group	54220.52	7	126.82	7745.79	31906.95	43.29	52.38	62.3
Suzlon Group	39463.57	2	4.38	19731.78	39459.19	63.49	64.69	65.89
Mahindra and Mahindra Group	31389.68	9	15.03	3923.71	17095.03	22.62	52.52	83.57
Essar Ruia Group	30213.75	3	80.85	10071.25	23950.52	18.57	43.89	65.85
Jaiprakash Group	30032.91	3	832.35	10010.97	26546.7	44.54	60.88	74.78

Notes: Business groups with more than one listed firm as reported in Prowess were considered. Groups comprising only of financial firms were excluded from the list. The maximum stakes as reported are sourced from the Prowess database.

Source: Author's computations based on data obtained from CMIE Prowess database.

While cross-country comparisons are somewhat difficult given that the reporting of equity ownership data is not uniform, broad comparisons with other countries suggest that the Indian corporate governance system can by and large be characterised as a *hybrid* of the Anglo-Saxon 'outsider' system of the US and the UK (characterised by diversified equity ownership and less involvement of lending institutions), and the 'insider' systems of continental Europe and Japan (characterised by a

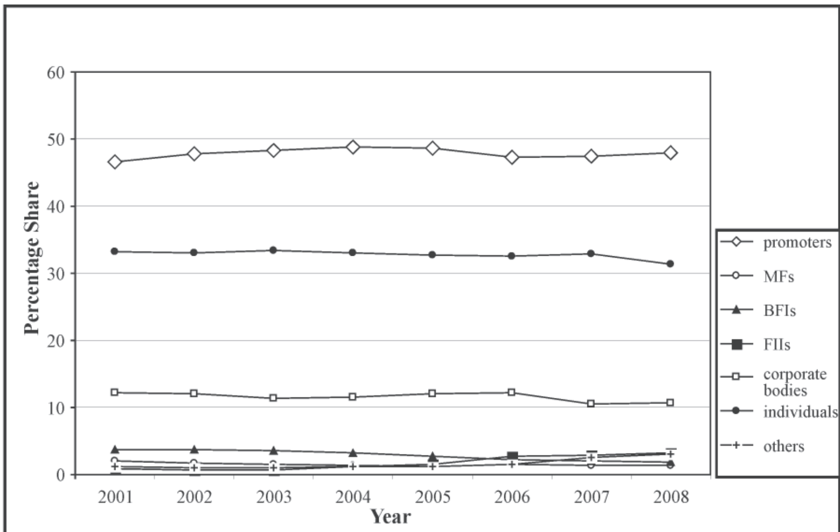
greater concentration of shareholder power residing with banks/families/ corporate bodies). Compared to other developing countries and the bank-based systems, India has a large number of listed companies—in fact the largest in the world—and while concentrated family ownership with its associated networks is the dominant ownership structure, the participation of the small investor in corporate equity in India is also not insignificant. Like the US and the UK, shareholder sovereignty is important in India. At the same time, equity holding by non-financial corporations in India (both as insiders and as outsiders)—a significant constituent of which is inter-corporate cross-holdings in group companies—is much higher than in the UK and the US and are more comparable to what is found in Germany and Japan.[14]

The prevalence of insider control in Indian companies and within business groups (as evident in Table 1) is in keeping with the persistence of concentrated ownership and control structures in India since the early years of Indian industrialisation in the colonial period and well into the post-independence period despite significant shifts in the institutional environment—from a regulated economy between the early fifties to the early nineties, to the increasingly liberalised environment since then (Khanna & Palepu, 2005; Sarkar, 2010). An examination of the evolution of concentrated ownership and insider control over a long duration in the context of India is constrained by the lack of comparable data mainly due to changing disclosure standards; the analysis of time trends can at best be limited to the period 2000–2001 to 2007–2008. This period is important nonetheless in view of the fact that several regulations since the nineties (such as those related to creeping acquisitions and share buy backs, changes in norms of entry for foreign institutional investors, as well as the partial privatisation of financial institutions) came into effect during this period and can be expected to lead to re-optimisation of equity portfolios in companies.

Two aspects of ownership trends are analysed, the first being the trends in the components of the aggregate ownership of an unbalanced panel of companies from Prowess for the period 2000–2001 to 2007–2008, and the second being the trend towards consolidation/divestment of insider and outsider ownership for a balanced panel of companies from Prowess during the period 2000–2001 to 2005–-2006. With regard to the first,

promoter ownership since 2001–2002 has consistently accounted for more than 46% of total equity, steadily increasing till 2003–2004, marginally dipping in 2004¬2005, and then touching the 48% mark in 2007–2008 (as indicated in Figure 2). Among institutional investors, BFIs remained the largest, although its equity stakes by and large declined over the eight year period, and by 2008 was almost half of its 2001 level. Like BFIs, the share of MFs too exhibited a declining trend, while FII ownership of Indian companies steadily increased, from being around less than 1% consistently during 2001–2003, to crossing the 3% mark in 2007–2008.

Figure 2: Trends in shareholding by major categories (2001-2008)



Source: Author's computations based on data obtained from CMIE Prowess database.

The second analysis of ownership trends examines whether there has been sustained consolidation or divestment of promoter ownership in some companies over time. Table 3 presents a balanced panel of 2120 companies between 2001–2006 (the set of companies by ownership groups in which promoter share ownership has increased, decreased, or remained unchanged over the period).[15] Additionally, taking all the interim years into consideration, the estimates are presented with regard to the set of companies that has undergone persistent *consolidation* (promoter share increasing continuously, from one year to the next, during the entire period), and the set that has undergone *persistent divestment* with a

consistently decreasing trend over the period. The key findings presented in Panel A and Panel B of Table 3 are highlighted in Box 1. While Panel A presents estimates of promoter consolidation/divestment, Panel B presents an analysis of the typical characteristics of firms in which promoters have increased/decreased their stakes during 2001–2006 in terms of market capitalisation (proxy for size), and promoter share, with the base year for comparison chosen as 2001.

Table 3: Trends and pattern of consolidation divestment of insider owners in Indian corporates (2001 and 2006)

A. Change in Promoter Share (prom_shr) between 2001 and 2006			
	Group Affiliates	**Standalones**	**All**
(1) Increase in prom_shr			
Number (%)of firms	421 (53.50)	594 (44.56)	1015 (47.88)
Median (mean) increase	4.87 (8.39)	6.01 (10.21)	5.70 (9.46)
(2) Decrease in prom_shr			
Number (%)of firms	318 (40.40)	568 (42.61)	886 (41.79
Median (mean) decrease	6.17 (10.13)	8.85 (13.06)	7.65 (12.01)
(3) No change in prom_shr			
Number (%) of firms	48 (6.10)	171 (12.83)	219 (10.33)
(4) Persistent Consolidation			
Number (%) of firms	28 (3.56)	34 (2.55)	62 (2.92)
(5) Persistent Divestment			
Number (%) of firms	16 (2.03)	22 (1.65)	38 (1.79)

B. Characteristics of Firms exhibiting change in prom_shr						
	Group Affiliates		**Standalones**		**All**	
	2001	2006	2001	2006	2001	2006
(1) Increase in prom_shr						
Median prom_shr	45.8	53.47	39.9	49.68	41.97	51.63
Median market cap	15.46	141.13	12.12	17.89	4.16	47.15
(2) Decrease in prom_shr						
Median prom_shr	53.17	45.65	52.79	39.5	53.1	41.76
Median market cap	18.08	140.01	3.12	15.65	5.23	37.54
(3) No change in prom_shr						
Median prom_shr	49.55	49.55	41.72	41.72	45.15	45.15
Median market cap	5.34	104.83	0.7	26.56	0.99	55
All firms in balanced panel						
Total number of firms	787	787	1333	1333	2120	2120
Median prom_shr	48.62	49.89	45.6	45.16	46.92	46.91
Median market cap	15.93	137.67	2.19	17.13	4.01	42.99
Mean market cap	330.51	1691.38	92.02	481.7	179.98	1027.93

Notes: Promoter share measured in percentage; market cap measured in Rs. Crore.

Source: Author's calculations based on data obtained from CMIE Prowess database.

Box 1: Trends in consolidation/divestment of promoter ownership (2001–06)

- Nearly half of sample firms (47.88%) have higher promoter share in 2006 as compared to their 2001 levels.
- A higher percentage of group affiliates have consolidated promoter share compared to standalones (53.50% and 44.56%, respectively) while the extent of consolidation is higher for standalones.
- Both the percentage of firms undergoing divestment as well as the average extent of divestment are lower for group affiliates (40.40% and 10.13%, respectively) as compared to standalones (42.61% and 13.06%, respectively).
- In the set of firms registering promoter consolidation, and those showing divestment, only a very small percentage have been achieved through 'persistent consolidation' or 'persistent divestment', (2.92% and 1.79% of the companies, respectively).
- In terms of size and promoter share, it is the median group-affiliate and the larger than median standalones with lower than average promoter share, that have consolidated.
- With regard to promoter divestment between 2001 and 2006, both group affiliates and standalones have in 2001 been on an average the larger than median firms in the sample with larger than median promoter ownership.
- Firms with no change in promoter share between 2001 and 2006 (although not ruling out off-setting changes in the interim years) are found to be on an average smaller than the median for the whole sample, and in the case of standalones, are among the bottom 25% of the sample.

The preceding analysis reveals that while both Type I and Type II problems are relevant in the Indian context, it is the latter type of agency problem that is of greater importance given the dominance and persistence of concentrated ownership and insider control in Indian corporates, both with respect to group affiliates and standalones. This is not surprising given that in emerging economies with relatively weak investor protection and rule of law, concentrated insider ownership is considered to endogenously evolve as an optimal response to mitigate Type I agency problems that affect widely-held corporations. In the case of India, while existing research shows that "laws in the books" both with respect to shareholder and investor rights are almost at par with international best practices, it the

rule of law, or "laws on the ground" that are weak (Sarkar & Sarkar, 2008). Thus shareholder monitoring costs in the case of separation of ownership and control in widely-held corporations are likely to be higher, which in turn explains the generic tendency towards maintaining concentrated insider control. The other key reason for the prevalence of concentrated ownership positions in Indian companies (including many of the largest companies) is that listed companies are highly leveraged with a relatively low equity base (on average). This allows insiders to control a significant portion of equity with relatively less investment.

Ownership complexity and opacity

While Type I agency problems are likely to be alleviated through concentrated ownership due to greater convergence of interests between inside and outside shareholders particularly in family dominated corporations in India where managers in most cases are *de facto* owners and the incentives to maximise the surplus is likely to be strong, this does not necessarily preclude the possibilities of expropriation of minority shareholders by insiders. As the Naresh Chandra Committee on Audit and Governance observed in the context of Indian companies (DCA, 2002), while a promoter who controls management and owns a majority stake is not expected to perform in a 'value-destroying manner,' the promoter (by virtue of being in control) can nevertheless act in a way that deprives minority shareholders their *de jure* ownership rights without necessarily affecting company profitability. As the theoretical discussion in Section 2 pointed out, the extent to which expropriation possibilities (i.e. Type II agency problems) are present largely depends on the complexity of ownership structures that arise from pyramiding, cross-holdings, and difficulties in tracking down the locus of ultimate control.

The historical perspective on ownership structures in India does testify to the presence of pyramidal ownership structures as well as cross-holdings in India from the very early years of business group formation (Hazari, 1966). That such structures are still prevalent is well documented in the existing literature (see for example, Bertrand et al., 2002; Masulis et al., 2009). Estimates based on 659 listed companies in India of which 189

are affiliated to 56 groups (Masulis et al., 2009) show that 10.02 per cent of the total sample of firms belong to a group and are controlled through a pyramid. Further, 4.10 per cent of market capitalisation of the sample firms is held by pyramid controlled firms.

One of the important aspects of the control structure of business groups that is evident from an analysis of control structures of other Indian business groups is that while family ownership is paramount, there is little *direct* ownership by family members. This is evident from the relatively low holdings by individuals in group affiliates but higher corporate holdings as compared to the overall average (as shown in Table 2), and largely reflects the fact that most business houses had developed as complex webs of companies and cross-shareholdings to take advantage of various government policies over the years.[16] This has left them with small, yet controlling stakes in group companies.

Apart from the complexity of ownership structure, an important source of agency costs in Indian listed companies that makes it difficult for an outsider to decipher the complete chain of ownership and control between firms is the *opacity* of ownership structure. Opacity is an important source of agency cost as it can help conceal the diversion and flow of expropriated funds. In the Indian context, one can identify three determinants of ownership opacity—the incomplete disclosure of the identity of owners, the fragmentation of insider ownership across a large number of owners, and the extent to which the ownership is in the hands of private entities. With regard to the first, between April 2002 and March 2006, disclosure regulations required listed firms in India to disclose the identity of only those equity holders *who have at least 1% share ownership*. Under such circumstances, ownership structure can be strategically engineered by controlling shareholders through the fragmentation of shareholding where individual ownership by insiders is deliberately kept at less than 1% to avoid mandatory disclosures. The larger the percentage of shareholding in the less than 1% cut-off and outside the public domain, the more opaque the ownership structure can be considered to be from the point of view of an outsider. This can be called Type I opacity. The second type of opacity

stems from the extent to which insider shareholding is 'fragmented' among its constituents; distributing a given shareholding among a large number of insiders again could potentially be an obstacle to efficient monitoring and could raise transaction costs. Opacity arising from fragmentation may be called Type II opacity. Finally (related to Type II opacity) is Type III opacity that could arise from the type of promoter shareholding, which can be classified into three distinct categories, namely individuals, listed companies, and unlisted companies and trusts. The more the weight of such shareholding is towards unlisted companies and trusts, the more it is unlikely for an outside minority shareholder, and even perhaps for outside members of the board of directors, to decipher chains of control as well as any related-party transactions. The ownership network becomes all the more complex if one considers additional cross-holdings by these private companies in group affiliates as is the case in many business groups.

Examining the different types of opacity for Indian listed companies, subsequent to the changed regulations since April 2006 which requires the identity of all constituents of promoters and promoter group along with their respective shareholdings to be disclosed under Clause 35, Type I opacity has almost been eliminated among listed firms. Prior to this period, the presence of such opacity had been documented by Sarkar and Sarkar (2008). However one finds considerable fragmentation of promoter holdings (Type II opacity) among listed companies—estimates across 3596 listed companies for March 2008 reveal that on an average a company has around twelve promoters, with the maximum across companies being as high as 46. Further, the mean (median) promoter shareholding within a company (a proxy for the extent of fragmentation) is only around 8 (5)%. Thus, while one finds significant concentrated ownership when all promoters are considered as a block, each promoter on an average has less than 10% shareholding. Given the data limitations, it is difficult to compute Type 3 opacity for all listed companies. Table 4 presents a detailed picture of Type 3 opacity along with the other manifestations of opacity for the flagship companies of the top four Indian business groups—Reliance Industries Limited of the Reliance Group, Reliance

Communications Limited of the Anil Dhirubhai Ambani Group (ADA Group), Tata Steel of the Tata Group, and Hindalco Industries of the Aditya Birla Group.

Table 4: Promoter ownership characteristics in selected companies (March 2008)

	Reliance Industries	**Reliance Communications**	**Tata Steel**	**Hindalco Industries**
A. Number of promoters by type				
All	48	11	16	19
Individuals	5	4	0	5
Listed Companies	0	1	5	7
Unlisted Companies & Trusts	43	6	11	7
B. % of holdings by promoter type				
All	50.95	66.13	33.94	31.43
Individuals	0.49	0.25	0	0.12
Listed Companies	0	0.89	5.23	8.05
Unlisted Companies and Trusts	50.46	64.99	28.71	23.26
C. Average promoter holdings by promoter type (B/A)				
All	1.06	6.01	2.12	1.65
Individuals	0.1	0.06	-	0.02
Listed Companies	-	0.89	1.05	1.15
Unlisted Companies and Trusts	1.17	10.83	2.61	3.32

Notes: ‘A’ lists the number of promoters constituting Promoters and Promoter Group as well as the number of each type of promoter (individuals, listed companies and unlisted companies and trusts). ‘B’ lists the total percentage of shareholding by promoter type, i.e., the percentage equity holding by promoters who are individuals, etc. ‘C’ is the average holding by type of promoter.

Source: Author’s computations based on promoter shareholding disclosed under Clause 35 and reported in Electronic Data Information Filing and Retrieval System (EDIFAR) of Securities Exchange Board of India (SEBI).

As can be clearly seen from Table 4, the different manifestations of opacity (Type II and Type III) are in-built in the ownership structure of these companies, but to varied extents. Considering Type II opacity related

to fragmentation, Reliance Industries has as much as 48 promoters, with an equity share of 50.95%, which comes to be an average share of only 1.06% per promoter. The corresponding estimates for Hindalco Industries, Tata Steel, Reliance Communications are around 1.6%, 2%, and 6% respectively, all three lower than the average of 8% obtained for the total sample. Further, what is of interest is that more than 50% of the promoters belonged to unlisted companies and trusts of different types including investment trusts, the highest being for Reliance Industries, at nearly 90%. Among the other types of promoters, individuals are a distant second, and listed companies are nearly absent. With regard to the percentage of equity holdings by the three types of promoters, unlisted companies and trusts overwhelmingly account (80–90%) for promoter equity in the case of all four companies (as shown in Panel B).

5. Role of large blockholders in the governance of Indian corporates

The analysis of ownership structure in the previous section reveals the prevalence of concentrated promoter ownership and control in Indian corporates. This section discusses the impact of different blockholders (both insiders and outsiders) on firm performance in light of several large sample-based empirical studies and anecdotal accounts related to large shareholder activism in India.

Blockholdings in Indian corporates

The ownership estimates presented in Table 1 were arrived at by clubbing the individual shareholdings listed under each *type* of shareholder, without applying any cut-offs for individual blockholdings. In defining blockholdings, one of the most common cut-off points that is used in the literature is the legal definition of blockholders under Rule 13d-1(a) of the Securities Exchange Act of 1934 in the US, which sets the threshold for blockholding at 5% or more. In the case of India, additionally, the disclosure of equity holdings of 1% or more can be exploited to analyse the incidence of each *type* of inside and outside blockholdings in greater detail.

Table 5 presents the estimates of blockholdings in Indian corporates (as of March 2006) for blockholdings defined over different thresholds starting from at least 5% equity ownership to more than 75% equity ownership, all of which have strong institutional bases derived from existing corporate law and securities regulations, specifically the Companies Act (1956) and the Substantial Acquisitions of Shares and Takeovers (SAST) Act (1997). Table 5 also highlights the distribution of companies by the type of the largest shareholder following the major ownership classifications in Clause 35.[17] The 5% threshold in the Indian case also represents the minimum level of shareholding under the SAST (1997), when an acquirer has to disclose his/her shareholding to the target company and to the stock exchanges where the shares of the target company are listed. As Selarka (2005) points out, the 5% level captures the potential threat tof a takeover in the sense that the incumbent management is aware of the existence of a potential threat of a takeover. A minimum of 10% holding entitles a shareholder to sue the incumbent management with charges of oppression or mismanagement.[18] Also, shareholders with a minimum of 10% of paid up voting capital can call an extraordinary general meeting. Under the SAST Act (1997), an acquisition of 15% or more shareholding by a potential acquirer of a company requires a mandatory public offer by the acquirer of another 20% of the target company's share. A cut-off of 20% is typically the minimum level of equity ownership that is necessary to control a corporation (La Porta et al., 1999). Under the Companies Act (1956), a stake of 26% or more entitles a shareholder to block special resolutions and to have a say in the management of a company. A 51% gives majority stake and allows wide control over management of the firm but is subject to blocking minority; a stake of more than 75% is not subject to a blocking minority. Also, under the Indian Companies Act (1956), important corporate decisions such as proposed mergers, the buyback of shares, altering the memorandum and articles of association require 75% in favour. The highlights of the analysis of blockholders for different thresholds for a sample of 1965 listed firms for which disaggregated data was available in 2006, is presented in Table 5 and Box 2.

Table 5: Percentage of companies with different levels of blockholdings and type of largest individual blockholder (2006)

Type of Owners	Percentage of companies with equity ownership						
	>=5	>=10	>=15	>=20	> 25	>50	>75
Companies with a blockholder, the largest blockholder being	92.87	76.69	56.39	42.8	30.74 [85.4] {13.0}	5.65 [57.3] {6.0}	0.51 [22.2]
Indian Promoters	73.75	75.18	76.44	76.46	76.82	79.28	70
Foreign Promoters	6.08	6.9	8.93	10.58	11.92	16.21	30
PACs	7.62	7.23	6.32	5.83	4.8	1.8	0
Foreign Institutional Investors	1.09	0.73	0.36	0.36	0.5	0	0
Mutual Funds	0.22	0.13	0.09	0	0	0	0
Banks and Financial Institutions	2.36	2.26	2.17	1.78	1.49	0	0
Private Corporate Bodies	4.05	3.18	1.98	1.78	1.49	0.9	0
NRI/OCB	0.99	0.99	0.72	0.59	0.33	0	0
Indian Public	0.99	0.53	0.27	0.36	0.16	0	0
Any other	2.85	2.85	2.7	2.26	2.48	1.8	0

Notes: Estimates are based on 1965 listed companies. Estimates within square brackets are for Germany, and estimates within curly brackets are for the UK.

Source: Estimates for Germany and UK sourced from Kaserer and Moldenhauer (2005). Estimates for India are based on author's calculations of data from CMIE Prowess database.

To examine the extent to which outside blockholders (in particular institutional investors) can potentially act as a countervailing block vis-à-vis insiders, Table 6 presents the following three scenarios—(1) when all major types of institutional investors, i.e. FIIs, MFs and BFIs, act as distinct voting blocks with no coordination among them; (2) when domestic institutional investors (MFs and BFIs) coordinate their actions and monitor insiders as a single voting block, with FIIs acting separately;

and (3) when all institutional investors together act as a unified voting block. It is important to note that while the classification of outside blockholders has not undergone much change over the years, there has been considerable churning within each category of blockholder in terms of the functional and ownership status of its constituents since the nineties, so that it is a priori difficult to predict which of the alternate coalition possibilities would obtain.

Box 2: Characteristics of blockholdings in sample companies (2006)

- 93% of firms have at least one shareholder owning 5% or more equity.
- About 43% of companies have at least one shareholder with 20% control rights, which is the cut-off for effective control in many corporations.
- 30% of Indian firms have at least one shareholder who can act as a blocking minority, which lies in between the high 85.4% for 171 listed German corporations, and the relatively low 13% for the largest 173 listed UK corporations.
- Strong presence of promoters in Indian companies, irrespective of the level of blockholding; more than 70% of the companies have an Indian promoter as a dominant shareholder for any cut-off considered.
- On pooling both the direct and indirect holdings of all promoters, the percentage of companies with insiders as a dominant shareholding block increases further to at least 95% across all thresholds.
- The percentage of companies with foreign promoters increases as the threshold level of blockholding increases.
- Among dominant outside blockholders, the percentage of companies where a private corporate body is a dominant shareholder is the highest across all thresholds.
- The presence of institutional investors (particularly MFs and FIIs) as dominant shareholders is at most 1%, and almost absent at higher thresholds.

As is evident from the estimates of Table 6, the percentage of companies with outside blockholders under scenario 1 starts at around 46% for threshold levels of 5%, and systematically reduces by close to half for every consecutive change in the thresholds, to account for none for the thresholds crossing 75%. This is roughly the case for the other coalition combinations among institutional investors, although the corresponding percentages are noticeably higher with increasing thresholds when all

institutional investors are considered as a voting block. However, from the viewpoint of minority shareholders, even under this 'best case' scenario (i.e. under scenario 3), the presence of outside blockholders in the sample companies is barely 10% for thresholds of 20% or above, which simply means that only 10% of the sample companies have institutional investors as a potentially controlling block. Contrast this with the 86% of companies having insiders as a block holding at least 20% equity (as shown in Table 6). Also, increasing thresholds lead to a declining presence of each type of institutional investors, with domestic financial institutions not featuring as a blockholder in any company once the threshold blockholding touches 50%.

Table 6: Percentage of companies with insider and institutional blockholdings (2006)

Type of Owners	>=5	>=10	.>=15	>=20	> 25	>50	>75
A. Companies with inside blockholder	95.21	93.49	89.92	86.21	80.51	38.78	3.87
B. Companies with institutional investors as blockholders	46.00	23.91	11.14	6.36	3.61	0.20	0.00
with no coordination, the largest institutional blockholder being –							
(i) FIIs	8.96	5.70	3.21	1.83	0.71	0	0
(ii) Mutual Funds	3.71	1.27	0.51	0.20	0.10	0	0
(iii) Banks & BFIs	11.50	6.51	3.36	1.73	1.22	0.05	0
C. Companies with coordination *between domestic institutional investors only,* the largest institutional blockholder being -	46.67	25.34	12.42	6.92	3.91	0.25	0
(i) FIIs	8.45	5.34	3.15	1.83	0.71	0	0
(ii) Mutual Funds + Banks & BFIs	16.74	9.72	5.24	2.49	1.63	0.10	0
D. Companies with *coordination among all institutional investors with –*	47.33	28.40	15.27	9.87	5.75	0.25	0.05
companies having the institutional investors as the largest block among outside investors	26.56	18.47	11.40	7.33	4.17	0.10	0.05

Notes: Estimates based on 1965 listed Indian companies. FIIs = Foreign Institutional Investors; BFIs = Financial Institutions.

Source: Author's calculations based on data obtained from CMIE Prowess database.

Given the several estimates of the incidence of blockholdings in Indian corporates, the basic conclusion that can be reached is that promoters are in control in a large majority of listed companies, and the potential for institutional activism across Indian companies when measured by the extent to which institutional investors can act as a countervailing force against promoters through their blockholdings is at best weak. This picture somewhat improves when one considers the incidence and characteristics of multiple blockholdings in the top 500 companies, although the fundamental feature of disproportionate insider control still remains. Such control is further enhanced by management control by insiders as is evident from an examination of insider influence in the management of Indian companies. Estimates based on 307 of the top 500 companies in our sample for which both director-level data and ownership data were available show that about 67% of the companies in the sample have promoters either as a chairperson or as a managing director on company boards, with 69% of group affiliates and 63%of standalones having such directors on their boards. As can be expected, the promoters in these companies have controlling stakes which are on an average 50% (49% for group affiliates, and 51% for standalones).

A fall-out of the relatively low equity stakes of outside blockholders (particularly institutional investors), is that apart from curbing the incentives of these blockholders to monitor as hypothesised under the alignment hypothesis, it blunts the effectiveness of the 'exit' option that can be exercised by them as a governance mechanism. Instead, the exercise of the 'voice' option is typically exercised in India as in bank-based governance systems in Germany and Japan by virtue of holding significant equity positions and/or having substantial debt exposure. Almost all debt contracts with banks in India carry a covenant that it will be represented on the board of the debtor company via a nominee director (CII, 1998). This is often the case with institutional investors too (World Bank, 2005). The government-owned mutual fund, the Unit Trust of India, as well as government-owned insurance companies generally have nominees on company boards.

Blockholders and corporate performance in India

The overall picture that emerges from the preceding analysis of the incidence and trends in equity ownership of blockholders in Indian corporates is that of pervasive insider control which has persisted over the years despite some divestment taking place. Outsider blockholding levels which determine the potential for institutional activism in firms with insider control has not been substantial both in absolute and relative terms, when compared to the extent of insider control. In fact, insiders have monopoly control in a significant number of firms with institutional investors remaining a minority.

Several researchers have examined the relationship between large shareholders and corporate performance in the context of India, in the context of the conflicting theoretical hypotheses on the impact of insider and outsider blockholding on corporate governance. The challenge for existing empirical studies on the effect of large blockholders has been to capture the impact of blockholders on the governance of corporates in measurable units. Three strands can be broadly identified from the survey of the relevant literature, particularly with respect to the US, namely (1) studies that have examined whether the presence of blockholders, both insiders and outsiders, have influenced major corporate decisions such as executive compensation, leverage, and takeover activity (Holderness, 2003); (2) studies on outside blockholder activism that have estimated short-term stock market reactions to announcements of shareholder initiatives, and the voting outcomes on shareholder proposals (Gillan & Starks, 2007); and (3) analysing the "ultimate question" related to blockholders and corporate control, i.e. the relationship between block ownership (insider and outsider) and firm value including the effect of outside blockholder actions with respect to a targeted company on the long term performance of the company (Holderness, 2003; Gillan & Starks, 2007). In India, the focus has been on the ultimate question of the relationship between large blockholdings and corporate performance. The other two types of studies have not been much researched till date, mostly owing to data limitations.

Under the performance approach, the net effect of corporate governance is captured in terms of how particular governance mechanisms affect overall firm performance. This has been the predominant approach adopted in governance studies, particularly in the context of developing and emerging economies as well as other bank-based developed economies where discrete events are few and far in between. Both accounting and market measures are taken as measures of performance, with each of these measures having their own advantages and disadvantages. Accounting measures could have comparability problems if companies in a country do not follow uniform accounting standards, in which case market measures may be more appropriate. On the other hand, market measures may be less reliable compared to accounting measures in countries with inefficient stock markets. Various empirical studies take different calls on this issue choosing one over the other, whereas some studies use both measures to generate more robust conclusions.

The appropriate selection of a performance parameter is particularly challenging in the case of emerging economy studies with relatively underdeveloped stock markets, and less stringent and non-uniform accounting standards. With respect to market measures, most studies in countries with developed stock markets (like the US and the UK) use Tobin’s Q and Market to Book Value Ratio (MBVR) as indicators of market measures of long term performance. MBVR is calculated as the ratio of the product of the number of equity shares and the closing price of the share on the last day of the financial year to the book value of equity and reserves. Tobin’s Q is defined as the ratio of market value of equity and market value of debt to the replacement cost of assets. While no specific computational adjustments are needed to compute MBVR for emerging economies, the calculation of Tobin’s Q becomes difficult primarily because a large proportion of the corporate debt is institutional debt that is not actively traded in the debt market. Also most companies report asset values to historical costs rather than at replacement costs. Thus the general practice in emerging economy governance studies that focus on market measures is to calculate a proxy for Tobin’s Q by taking the book value of debt and the book value of assets in place of market values.

In general, market-based indicators are preferred to accounting indicators when analysing company value for at least three reasons. First, while accounting indicators incorporate only current information regarding the performance of the company, market-based indicators incorporate both current information as well as future prospects, and as such are likely to better reflect the overall financial health of the company. Accounting measures also have the potential problem of requiring a longer time to reflect the effects of governance. Third, market-based indicators reflect the valuation of the company by a large number of independent investors and are therefore likely to be more accurate than accounting indicators which may be subject to accounting practices specific to the company. Ideally, and under strict international accounting standards adopted by most developed countries, accounting indicators should be highly correlated with market-based indicators. However this is not necessarily the case in developing countries with reportedly low quality accounting standards (La Porta et al., 1998).

Box 3 presents a list of chronologically published empirical studies on the effect of large shareholders on firm performance in India. As can be seen from Box 3, the data-sets used in the studies have dated from the pre-reforms period (Chhibber & Majumdar, 1999), to several years into the implementation of governance reforms, i.e. 2004 (Pant & Pattanayak, 2007). Further the samples for all the studies except one have been drawn from the Prowess database, although differences exist among the samples in terms of their coverage. While some studies included only listed firms, others included unlisted firms as well; some included only manufacturing firms, others included both manufacturing and non-manufacturing firms. However, in terms of size, no sample is less than 1000 private sector firms, delineated by the different ownership groups. All the studies without exception have been conducted within a multivariate framework, examining the effect of different types of block ownership on firm performance after controlling for a host of other firm and market characteristics that are considered in the literature to influence firm performance. More recent studies (Kumar, 2008) have also taken into account the impact of possible endogeneity between ownership and firm performance.

Box 3: Summary of empirical research on large shareholders and performance in India (1999–2008)

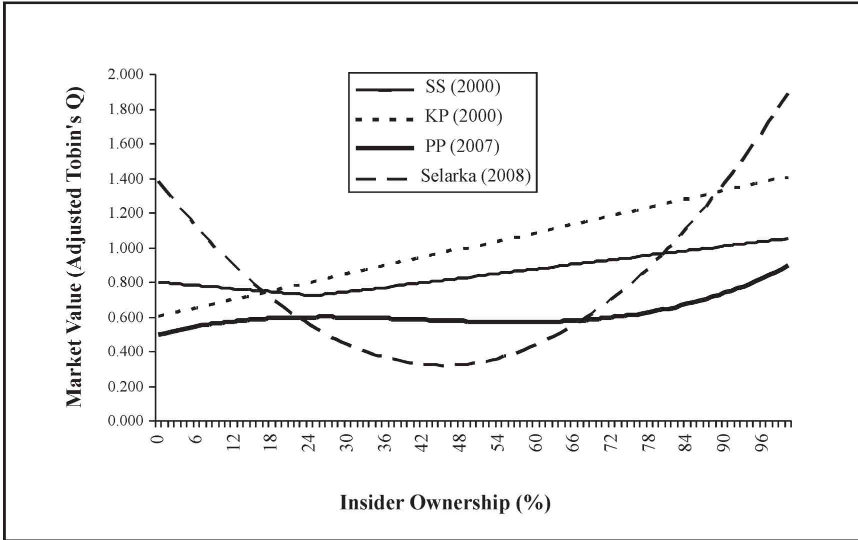
Paper	Sample	Firm Performance Measure	Variables of Interest	Findings
Chhibber and Majumdar (1999)	1001 private sector firms for pre-1991 and post-1991 period	Return on Assets and Return on Sales	Shareholdings by Foreigners	Foreign ownership has no effect on firm performance in the pre-1991 period. It positively affects firm performance in the post-1991 period but only after attaining majority shareholding of 51% or more.
Khanna and Palepu (2000)	Private sector listed firms for 1993	Market value of firm measured by Tobin's Q	Shareholdings by Insiders and Directors, Domestic Financial Institutions and Institutional Investors, Foreigners, and Top 50 owners	Foreign ownership has positive effect on firm performance. No effect of domestic financial institutions. Positive effect of insiders on firm value.
Sarkar and Sarkar (2000)	1567 private sector manufacturing firms for 1995–1996	Market value of firm measured by Market to Book Value Ratio (MBVR) and Tobin's Q	Shareholdings by Insiders and Directors, Corporate Bodies, Domestic Financial Institutions and Institutional Investors, and Foreigners	Foreign ownership has positive effect on performance. Insiders, corporate bodies and domestic financial institutions increase firm value beyond a threshold ownership of 25%. Domestic institutional investors have no effect on Tobin's Q, and negative effect on MBVR for ownership less than or equal to 25%.

Paper	Sample	Firm Performance Measure	Variables of Interest	Findings
Selarka (2005)	1397 listed manufacturing companies for 2001	Market value of firm measured by Market to Book Value Ratio (MBVR) and Tobin's Q	Shareholdings by Promoters (Insiders), and Outside Blockholders (Domestic financial institutions and institutional investors, foreign institutional investors and private corporate bodies	Insider ownership less than 46% has negative effect on MBVR, positive effect thereafter. Corporate bodies have negative effect at intermediate land high levels of ownership while blockholdings by banks and institutional investors have no effect.
Douma et al. (2006)	1005 private sector manufacturing firms for 1999–2000	Market value of firm measured by Tobin's Q and Return on Assets	Shareholdings by Insiders and Directors, Domestic Financial Institutions and Institutional Investors, Foreign corporations and Foreign Institutional Investors	Evidence of linear relationship between insider shareholding and firm performance.
Kumar (2008)	Unbalanced panel of 2478 listed manufacturing firms/5017 firm-year observations for the period 1994–2000	Return on Assets and Return on Equity	Shareholdings by Insiders and Directors, Corporate Bodies, Domestic Financial Institutions and Institutional Investors, and Foreigners	Foreign ownership has no effect. Domestic financial institutions and institutional investors with at least 15% stakes increase firm value. Positive effect on firm value for insider stakes of at least 24%.
Pant and Pattanayak (2007)	1,833 private sector listed firms/7330 firm year observations for the period 2001–2001 to 2003–2004	Market value of firm measured by Tobin's Q	Shareholdings by Promoters (Insiders)	Insider ownership less than or equal to 20% has positive effect on firm value; stakes exceeding 20% but less than or equal to 49% have negative effect on value. Stakes beyond 49% have positive effect on firm value.

With respect to the effect of insider ownership, the focus of several studies in the Indian context has been to examine the relative strengths

of the alignment versus entrenchment effects on firm performance, the former effect predicting a positive relationship between ownership and performance, and the latter a negative relationship. With the exception of Khanna and Palepu (2000), all the other studies postulate a non-linear relationship between inside ownership and performance to account for the possibility that the incentives of insiders, and the associated costs and benefits of the alignment and entrenchment effects change with their shareholding levels. While the ownership disclosure framework prior to 2000 allowed an examination of the effect of insiders as subsumed under managerial holdings (similar to the US studies) as well as family holdings (Douma et al., 2006; Khanna & Palepu, 2000a; Kumar, 2008; Sarkar & Sarkar, 2000), the later set of studies (using the post-2000 classification) sought to capture the effect of controlling insiders on firm performance as is usually defined in studies in non-US settings (Pant & Pattanayak, 2007; Selarka, 2005). The dominant picture that emerges from the existing body of evidence is that insider ownership and performance are non-linearly related to the relative strength of the alignment effect vis-à-vis the entrenchment effect, changing with changes in ownership. The indicative relationships obtained in some of these studies are presented in Figure 3. While support for a piece-wise linear relationship is found in both Sarkar and Sarkar (2000), and Kumar (2008) indicating that the benefits of the alignment or convergence of interests between insiders and outside shareholders outweighs the negative entrenchment effects once the promoter ownership crosses a threshold of around 25%, both Selarka (2005), and Pant and Pattanayak (2007) find a quadratic and cubic relationship respectively, which still supports the basic finding that the interests of controlling insiders and minority outsiders converge once insider control becomes sufficiently high.

Figure 3: Relationship between insider ownership and market value of Indian corporates—Results from select studies



Notes: To make a comparison of the qualitative relationship between insider ownership and firm value, the intercepts from the various studies have been normalised to the same value.

Source: SS (2000) = Sarkar and Sarkar (2000); KP (2000) = Khanna and Palepu (2000); PP(2007) = Pant and Pattanayak (2007).

With respect to outside blockholders, as is evident from Box 3 the empirical studies in the Indian context have exploited cross-section/time-series variation in outsider blockholdings in Indian companies (similar to the focus in other countries) to examine whether higher blockholdings by outsiders are associated with higher firm value (the efficient monitoring hypothesis), or are blockholders passive investors (the strategic alignment hypothesis), with no effect, or even worse, an adverse effect on performance. The latter possibility is suggested by much of the existing anecdotal evidence on shareholder activism in India.[20] Theoretically, shareholder 'activism' or the lack of it (shareholder passivism) is defined in the literature (see for instance, Black, 1990; Rho, 2007, among others) as the ability of outside shareholders to use the exit or/and the voice option to impact on the policies pursued by a company's management (Gillan &

Starks, 2007), and to broadly influence firm behaviour and governance rules (Black, 1998). Ideally, institutional shareholder activism should be captured in terms of the level of institutional activity with respect to interventions in board decision making and the like, and the resultant effect on corporate performance (as pointed out by Short & Keasey, 2005). However such data are in most cases not publicly available, and hence the level of institutional shareholding is taken as a reasonable proxy for the level of monitoring activity, the implicit assumption being that higher shareholding necessarily leads to higher monitoring, which translates into higher performance. Such issues should be kept in mind while interpreting the results of empirical estimation, and drawing conclusions from such research (Short & Keasey, 2005).

As is evident from Box 3, the evidence on the role of domestic institutional investors is mixed. Some studies which consider domestic financial institutions, insurance companies, and mutual funds as one block (Khanna & Palepu, 2000; Douma et al., 2006) find no evidence of the monitoring role of domestic financial institutions and institutional investors. The explanation of both Khanna and Palepu (2000) and Douma et al. (2006) is based on the fact that these investing institutions (during the period of their respective studies) were predominantly government-owned and hence did not possess either the incentives or the ability to monitor; the nominees of financial institutions may not have the experience or the incentive to be effective as their tenure and remuneration do not depend on the performance of their portfolio companies. Relaxing the assumption that all domestic financial institutions and institutional investors can be treated as a single block in view of the fact that the underlying motivation, and hence the monitoring incentives of these institutions are likely to be different (notwithstanding the government ownership of these institutions) Sarkar & Sarkar (2000) find that while institutional investors are passive monitors, for banking institutions, the firm value rises once these have substantial stakes (≥25 per cent) in companies. The mixed empirical findings on the governance role of financial institutions and institutional investors in India are not an exception when compared to the findings with respect to other countries (Black, 1998; Gillan & Starks, 2007).

With regard to the impact of foreign institutional investors on firm performance, the key result of the existing empirical studies on India is that foreign investors considered together have a positive effect on firm performance, although the debate is still on as to whether FIIs among them are active in governance. Anecdotal and survey-based evidence on FII activity in India in general suggest that FIIs are less passive than domestic institutional investors. As in the case of domestic investors, given the relatively small holdings of FIIs in a large number of companies, the potential for them to influence decision-making in companies through exercising the exit option is rather limited. FIIs in India are found to exercise the voice option relatively more than domestic institutional investors, through their attendance and voting at meetings, as well as through convening informal meetings with management. However like their domestic counterparts, FIIs are largely found to support incumbent management (World Bank, 2005).

The activism of FIIs in India came into sharp focus for the first time when, together with domestic institutional investors, they were successful in forcing Satyam Computer Services Limited to backtrack on the planned acquisition of two other group companies that had been approved a day before by its board (the plans were well within the law since it did not require a special resolution by shareholders). This was accomplished by offloading stocks over a window of just two days, during which the stock price of Satyam fell drastically, forcing the promoters of Satyam to call off the proposed acquisitions. Institutional activism mattered in the case of Satyam primarily due to institutional investors (particularly FIIs) having substantial equity in the company (around 48%) which together with the equity holdings of domestic institutional investors (around 13%) far outstripped the promoter holdings (around 9%).

While the Satyam case is considered as a watershed event in successful institutional activism in India and is consistent with the general finding of empirical studies that the effectiveness of monitoring by institutional investors increases with the increase in their holdings, ironically it is also an illustrative example of institutional passivism. When foreign institutional

investors as well as domestic financial institutions steadily increased their equity exposure in Satyam, the beginnings of the accounting fraud at Satyam took root. This could be interpreted as a sign of institutional passivism as one can argue that had the external blockholders (both domestic and foreign institutional investors) been engaged in continuous monitoring, the financial irregularities could not have built up over time. Although the investors were diligent enough to question the acquisition decision, what was also expected of them was their governing role in *ex-ante* prevention.

The conduct of institutional investors with respect to Satyam can be understood in light of the survey-based finding that institutional investors screen management of a firm *ex-ante* at the time of considering an equity investment in the firm, but once the investment is made, they support management decisions. It is only when they lose confidence in management due to ‘discrete events’ that they exercise the exit option (World Bank, 2005). The exit mechanism was effective in disciplining the Satyam management because of the large institutional equity position in the company and the coordinated action across the different types of investors.

6. Insider control and expropriation: Select evidence

While the complexity and opacity of ownership structures as seen in the Indian context can potentially result in Type II agency problems leading to expropriation of minority shareholders by controlling insiders, what does the evidence suggest?

As was discussed earlier, one of the key ways in which minority investor expropriation can be undertaken via the ownership structure of a firm is through tunnelling. Specifically, while the incentives for tunnelling in the Indian context lie in the pyramidal structures of business groups and the cross-holdings often amounting to circular chains of ownership, the ability to tunnel depends on a host of factors that include the opacity of ownership structures, the conduct of related-party transactions, the issue of debt, earnings manipulation, and internal capital markets for

intra-group borrowing/lending. Further, a crucial point is that while these characteristics create the incentives for tunnelling and hence the potential for minority shareholder expropriation, this does not necessarily imply the existence of minority shareholder expropriation. It is also important to note in this context that tunnelling by its very nature is clandestine, and hence cannot be easily deciphered and may not be conclusively proved (Bertrand et al., 2002. In fact, cases of tunnelling have usually come to light only after a corporate crisis—like with Parmalat in Italy, and Satyam in India. Whatever the scale of the failure and the diversion of funds through tunnelling for private benefits of control of insiders, minority shareholders suffer under all circumstances.

There have been essentially two sources of evidence across countries on minority shareholder expropriation—the first, an examination of individual cases following corporate collapses or due to allegations of complaints made and cases adjudicated, and the second, large sample empirical studies attempting to examine whether such expropriation exists via the various mechanisms of tunnelling. Both types of evidence exist with respect to Indian corporates. With regard to the first, specific cases of diversion of funds have been identified in recent years under the aegis of the Serious Fraud Investigation Office (SFIO) set up by the Government of India in 2003 to investigate financial frauds that involve public interest substantially either in terms of monetary misappropriation or in terms of persons affected (under the limits of the Companies Act, 1956). Between 2003 and March 2010, 767 cases of misappropriation and diversion were filed with the SFIO against 31 companies.[21] An examination of the nature of select cases under the SFIO based on information available in the public domain show that company promoters were in large part alleged to be instrumental in diverting funds and defrauding minority shareholders through various means. For instance the SFIO found that Daewoo India siphoned and diverted funds, manipulated accounts, and engaged in improper invoicing.[22] The Satyam fraud was the most serious of all the cases in India in recent times which involved the falsification of accounts (by the promoters) to the tune of around Rs. 7000 crore.[23] The Satyam

fraud also highlights how in concentrated ownership systems with insider control, the controlling shareholders have the power to indulge in self-dealing and to extract private benefits of control by manipulating financial transactions as well as financial statements, without the knowledge not only of the minority shareholders but also of the other members of the board of directors.

Apart from cases investigated by the SFIO, cases of shareholder oppression, mismanagement or apprehension of mismanagement of the company are adjudicated by the Company Law Board (CLB) in India under Sections 397/398 of the Companies Act, 1956. During the financial year 2008-09, a total of 931 cases under Sections 397/398 were placed before the CLB of which 186 were disposed off.[24]

With regard to the second source of evidence on the extraction of private benefits of control by controlling shareholders in India, there are only a few large sample studies which have empirically tested for minority shareholder expropriation especially in business groups. Based on an analysis of Indian business groups, Bertrand et al. (2002) find evidence of tunnelling—a transfer of resources from group firms in which promoters have low cash flow rights but high control rights at the bottom of the pyramid, to those where promoters have higher cash flow rights at the top of the pyramid. Based on a sample of 18,500 firm-year observations, the authors find that the profits of group firms exhibit lower sensitivity to industry shocks than standalone firms, and that this sensitivity is lower for firms where the directors' share (a proxy for shareholders' ownership) is low. The lower sensitivity of group affiliates suggests that the profit of a group firm low down in the pyramid and belonging to the particular industry responds less relative to a standalone (despite receiving a positive industry shock) possibly because the group firm transferred its unexpected increases in profits to its member firms. This conclusion is further strengthened by evidence that group firms' profits respond to shocks to other firms in the group belonging to unrelated industries, and within this set this sensitivity is higher in firms in which owners have higher ownership rights and accordingly higher benefits from tunnelling resources into these firms.

Among the other studies examining the phenomenon of minority shareholder expropriation are Saha (2010) which analyses the relationship between tunnelling and related party transactions (RPTs), and Sarkar and Sarkar (2008) which analyses the effect of ownership opacity on the incentives for minority shareholder expropriation through debt. The use of RPTs as a conduit for minority shareholder expropriation has increasingly been examined with respect to several emerging economies, including India. In India, the extensive data analysis of related-party transactions in Saha (2010) reveals that for a sample of 5394 Indian firms as of 2003–2004 and 2004–2005, group firms engage in such transactions with their holding companies to the tune of 25% of their assets as compared to only 2% for standalones, and with respect to parties in control to the extent of 30% of total assets as compared to 19% for standalones.[25] The differences in both the cases are statistically significant. Significant differences also exist with respect to the type of related-party transactions, particularly with respect to payables and receivables as well as the net credit lending (payables minus receivables), which are significantly higher for group affiliates relative to standalones. While RPTs in principle need not necessarily imply expropriation of minority investors and can instead be associated with enhancing efficiency in terms of lower monitoring costs vis-à-vis anonymous market transactions (Gordon & Palia, 2004), the evidence from select emerging economies as well as developed countries point to their use for the benefit of controlling shareholders. For instance, the collapse of the family-controlled Parmalat in Italy (a classic example of controlling shareholder expropriation to enrich family members) was perpetrated by family-controlled management and advisors through illicit RPTs with the company's offshore subsidiaries and special purpose entities (McCahery & Vermeulen, 2005).[26] Evidence regarding firms that belong to Chinese corporate groups also reveals that free cash flows have been diverted to controlling shareholders through RPTs (Jian & Wong, 2003). In India, the preliminary evidence on the relationship between RPTs and tunnelling does point to the association between tunnelling incentives and RPTs, and therefore the existence of minority shareholder expropriation (Saha, 2010).

With regard to the evidence of expropriation through debt in the Indian context, Sarkar and Sarkar (2008) highlight how the issuance of debt by controlling shareholders can facilitate expropriation of minority shareholders in their analysis of a sample of group-affiliated and standalone firms. As argued in the extant literature, with controlling insider stakes together with ownership complexity in terms of pyramiding and cross-holdings, debt can per se facilitate expropriation by enabling shareholders to increase their control over group affiliates. By increasing the proportion of debt relative to equity in the capital structure, insiders can have greater control over the resources of group affiliates without having to commit additional equity (Harris & Raviv, 1988; Stulz, 1990). This increase in control—transmitted through pyramids as well as cross-shareholdings—in turn can create more tunnelling opportunities for expropriating minority shareholders. Moreover, by issuing more debt in affiliates where they have low cash flow but high control rights, the controlling shareholders can potentially increase the resources that can be siphoned off from these affiliates through intra group loans, or transfer pricing to ones where their cash flow rights are higher (Faccio et al., 2001a; Ellul et al., 2006).[27] Large-sample evidence on expropriation through debt is found in Sarkar and Sarkar (2008) who (in their study of 1266 firms comprising group affiliates and standalones) test the hypothesis that higher levels of debt are associated with higher vulnerability of expropriation as measured by the different indicators of ownership opacity discussed above. The crux of their finding is that while opacity does not affect firm value for standalones, it is associated with a discount in value for group affiliates. Additionally, more opaque and group-affiliated firms with fragmented ownership structures are more leveraged.

7. Conclusion

The data analysis of the incidence of different types of blockholdings, and the detailed discussion of the empirical evidence on the impact of insider and outside blockholdings on firm performance since the mid-nineties lead to several important conclusions with policy implications.

The first is the pervasiveness of insider control in Indian corporates that has persisted over the years. While some firms have consolidated and some have divested their insider holdings, the overall picture has not changed much. Outside blockholders seldom have controlling stakes in corporates, or the ability act as a countervailing force against insiders, although the picture is somewhat better for larger firms.

With regard to the empirical evidence on the effect of inside blockholding, the common thread running through a majority of the studies is that the relationship between insider ownership and company performance is essentially non-linear, lending credence to both the alignment and the entrenchment hypotheses. While insider entrenchment and its adverse effects on company value are evident at low to intermediate levels of stockholdings, insider ownership has a positive effect on performance beyond a threshold. Outside blockholders can be a mitigating mechanism in the face of pervasive insider ownership and control, but the weight of the overall evidence with respect to governance by institutional investors is towards institutional passivity. The passivity of institutional investors at all levels of equity ownership strengthens the profile of institutional nominees drawn up in several accounts in the literature—nominees who seldom use the voice option as they have little expertise in the specifics of the company they monitor, and who have no risk of loss to bear if the value of an investment declines, and no reward to gain if the value increases.

In the face of institutional passivity in governance, and the potential for minority shareholder expropriation given the dominance of business groups with complex and opaque ownership structures (along with anecdotal and empirical evidence pointing towards such expropriation), governance reforms have been geared towards strengthening the voice mechanism of outside shareholders and facilitating low-cost exit. Reforms in the capital market for instance have involved institutional changes in both the primary and the secondary capital markets through the higher disclosures and reporting requirements in the listing agreement, the introduction of screen-based trading to ensure transparency in operations, the move towards nationwide integrated markets, the guaranteeing of all trades by a clearing house, and the dematerialisation of securities. Such

reforms have helped to increase market efficiency by helping investors to assess the true underlying performance of companies, and by reducing the costs of transactions, i.e. brokerage costs, market impact cost, paperwork, fraud and counterparty risk in the secondary capital market. In the context of the protection of minority investor rights, while provisions in the existing Companies Act (1956) have been considered to be at par with best-practice, the new Companies Bill (2009) has proposed the strengthening of existing laws even further through the provision of class action/derivative suits on behalf of depositors/shareholders that could force promoters and managers who are found guilty of misfeasance/fraud to pay the legal costs; it also highlights the need for proper and timely disclosures to safeguard the interests of the investors.

Given the pervasiveness and persistence of insider control, the moot point remains as to whether large shareholder oversight can in practice function as an effective governance mechanism in the Indian context (barring a few exceptional and isolated cases). The data analysis and empirical evidence in this paper reveals that given non-controlling shareholding, and little potential for increased consolidation in most cases, outside blockholders are likely to be ineffective on a continual basis through the exit and the voice mechanism. In such a scenario, the burden of governance—ensuring that controlling owners act in the best interest of all shareholders and do not engage in malfeasance—has to be borne disproportionately more by other internal and external governance mechanisms such as the board of directors, audit committees, and the market for corporate control.

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Notes

[1] The analysis in this paper omits from its purview the governance issues in state-owned enterprises in India. While several state-owned enterprises have gone for partial disinvestment and are listed companies, the control of these enterprises still lies with the government, and they are subject to the policy framework laid out by the government. The literature recognises fundamental differences and basic non-comparability in the governance problems of state-owned enterprises and private sector enterprises in terms of their maximisation objectives, their control structures, their employment and compensation policies, accountability, the extent of autonomy from government, and the like. Hence the governance guidelines for state-controlled enterprises are usually issued separately (see for example, GOI 2007; OECD, 2005).

[2] In firm D, the controlling shareholders are entitled to only 13% of the profits, while in firm A, the shareholders are entitled to 51% of the profits. Tunnelling allows the profits from firm D to be transferred to firm A (say through overcharging firm D on some goods or services) which while benefitting the controlling shareholders of firm A will adversely affect the minority shareholders in firm D.

[3] For instance, in the case of a poorly performing investment, the institution can dispose of its investment rather than try to pressurise the management to improve performance. While this would be an efficient monitoring mechanism in the presence of an active takeover market like tin the US and the UK, minority investment interests are likely to be adversely affected in countries without such a market.

[4] The listed firms belonging to the 'Z' category are excluded.

[5] PACs are identified based on specific definitions provided by SEBI (for example, in the case of an individual, PACs by definition include a promoter's spouse, parents,

brothers, sisters, or children, while in the case of a body corporate, PACs would include a subsidiary or holding company of that body corporate, or any company in which said body corporate holds 26% or more of the equity share capital. For further details, see http://www.sebi.gov.in/Index.jsp?contentDisp=Section&sec_id=1 (Accessed on 18 August, 2010).

[6] The term control was defined under regulation 2(1) (c) of the Act, and included the right to appoint a majority of the directors or to control the management or policy decisions "exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner".

[7] This in turn is based on Explanations I, II, and III to sub-clause (m) of Clause 6.8.3.2 of the SEBI (Disclosure and Investor Protection) Guidelines, 2000.

[8] For further details, see http://www.sebi.gov.in/circulars/2006/dilcir132006.pdf (Accessed on 18 August, 2010).

[9] Prior to 2001, all foreign holdings (irrespective of whether these were promoter holdings or institutional investments) were clubbed under one category—"foreign owners."

[10] Individuals are further classified into those holding nominal share capital upto Rs. 1 lakh, and those holding nominal share capital exceeding Rs. 1 lakh.

[11] For instance, Claessens et al. (2000) recognise the problem of omission bias in the context of computing ownership data and tracing the ultimate owner in East Asian corporations. Of the 5284 corporations considered, the data for 1164 companies were missing or insufficient (covering less than one of the ownership rights). Lins (2003), analysing ownership structures in a cross-section of emerging economies, had to eliminate China and Poland from the sample on account of not being able to identify 90% of the blockholdings in half the sample firms.

[12] This is the standard cut-off applied in the literature to define widely-held firms (see Faccio & Lang, 2002; La Porta et al., 1998).

[13] Comparisons are based on the samples analysed in select European countries in Faccio & Lang (2002), in East Asian countries in Claessens et al. (2000), and in the US in La Porta et al. (1999).

[14] For a comparison of equity ownership of India with the other countries prior to 2001, see Sarkar and Sarkar (2000).

[15] A balanced panel of 2120 companies from the larger data set allows one to track ownership trends for any company for all six years.

[16] For instance, Goswami (2000) observes that in response to restrictions on private sector activities prior to the nineties, accounting and legal strategies were devised to ensure that business groups continued to control their companies while at the same time avoided high corporate and wealth taxes to the extent possible. This was achieved by owning companies, not through individual shareholding, but through ownership of trusts, small investment and finance companies, and through a complex web of indirect holdings.

[17] This exercise is fashioned along a similar exercise undertaken by Franks and Mayer (2001) to analyse ownership and control of German corporations.

[18] To reflect the interest of the minority shareholder, a 10% criterion is used for companies with share capital under Section 395 of the Indian Companies Act (1956).

[19] While there is a sizeable proportion of companies in which a corporate body represents the largest shareholder among blockholders (as shown in Table 6), the reason institutional investors are more potent as outside blockholders is that they often coordinate their actions and are more likely to act as a unified block than non-promoter corporate bodies, each of which is a distinct entity and may have different motives for holding relatively large equity positions in a particular company.

[20] See for example, World Bank (2005).

[21] For details, see http://www.sfio.nic.in/websitenew/in%20SFIO.pdf (Accessed on 18 August, 2010).

[22] For details, see http://www.financialexpress.com/news/serious-fraud-by-daewoo-37-m-sent-to-korea/120775/ (Accessed on 18 August, 2010).

[23] For details, see http://economictimes.indiatimes.com/infotech/software/Satyam-diverted-foreign-earnings-SFIO/articleshow/4422469.cms (Accessed on 18 August, 2010).

[24] Of the 931 cases, 355 fresh cases were received during 2008–2009. For details, see http://clb.nic.in/yrly2k8-2k9.htm (Accessed on 9 September, 2010).

[25] Saha (2010) notes that the total RPT as a percentage of total assets, aggregated across different categories constitutes about 74.67% in group-affiliates, and 34.53% in standalones.

[26] McCahery & Vermeulen (2005) add that the Parmalat case is not unique by itself, and several other companies with complex and opaque set-ups have emerged in continental Europe.

[27] Faccio et al. (2001a) argue that one of the reasons behind the high levels of debt precipitating the East Asian crisis was the “unmistakably” systematic expropriation by insiders via the use of debt, aided and camouflaged by ineffective capital market institutions, complex corporate pyramiding and extensive access to related-party loans.

10

Corporate Governance in an Emerging Market: What does the Market Trust?

Rajesh Chakrabarti, Subrata Sarkar*

1. Introduction

As the interest in corporate governance among researchers and practitioners soars around the world, there has been a proliferation of measures and indexes that seek to describe and measure this complex and largely qualitative concept. Market returns have also been associated with select corporate governance variables, though the debate about the impact of the latter continues. Nevertheless, there is little clarity over what market participants view as a meaningful indicator of corporate governance (or at least one or more of its dimensions). The divergence between what are now textbook measures of corporate governance and those that investors actually care about is likely to be particularly pronounced in the setting of an emerging market, where institutional gaps often compromise the validity of certain measures that may be effective in developed markets.

One way of establishing the corporate governance indicators that matter to specific markets would be to analyse the market performance of a large number of stocks to a particular corporate governance event that sends out a market-wide shock not confounded by any other major development.

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Assessing the cross-sectional variation of individual firms' reactions to such a shock, and relating this to their respective corporate governance indicators may indicate what the markets trust as indicators of corporate governance quality. Without ascribing omniscience to the markets, such an analysis could prove useful to policy makers and equity market regulators by helping them to focus on those variables that the market bets on rather than those that appear to be meaningful from traditional and theoretical analyses of corporate finance and governance.

It is however extremely difficult to come across such well defined events related to corporate governance that have market-wide impact. Cases of major corporate misgovernance typically unravel over a period of time, and are often associated with other developments unrelated to corporate governance, making a statistical analysis of their implications extremely difficult.

The corporate governance scandal involving Satyam Computer Services Limited (now known as Mahindra Satyam), the fourth largest software company in India, that occurred in December 2008 and January 2009 provides two such clean and major corporate governance events which affected firms across the board in India (and possibly other emerging market countries). These events, which are discussed in detail in the next section, are particularly suitable for the kind of analysis suggested earlier on several counts. The events were completely unexpected by the market, and involved a firm that was highly feted (decorated with awards for corporate governance to boot), with its American Depository Receipts (ADRs) trading at the New York Stock Exchange (NYSE). Moreover, these events happened in a country that had until then enjoyed an international reputation for its high degree of professionalism and healthy competition in the software industry. Equally importantly these events were big enough to rock the entire Indian market on both days, and made headlines for months afterwards. They made for the biggest news events on both days, and major Indian market indices dipped on both occasions. A very transparent national-level government and regulatory enquiry was initiated to investigate the affair; the following weeks witnessed an exodus of non-

executive directors from several boards in India. So these two events can be viewed as purely corporate governance events, as uncontaminated by other market developments as we can hope to get them. Consequently we argue that these events served as wake up calls for investors to review the quality of corporate governance in the respective firms, and that the variation in the market returns across the firms on those two days—suitably adjusted for overall market reaction—reflects the variation in the investors' perception of the quality of governance in these firms. Associating these abnormal returns to the corporate governance indicators commonly used in the literature would therefore reveal those measures that really matter for the markets and those which are largely inconsequential.

The rest of the paper is organised as follows. The next section describes the two Satyam related events and their overall impact on the Indian market. The third section discusses the data and methodology adopted for this study. Section 4 describes the results, while the last section concludes the paper.

2. Corporate governance scandal at Satyam: A background

Satyam Computer Services Limited, the Hyderabad based Indian software company, was founded in 1987 by B. Ramalinga Raju and his brother B. Rama Raju. Ramalinga Raju served as Chairman of Satyam from 1995 to January 7, 2009, and served on several corporate boards, including those belonging to the Satyam group. He served as Chairman of the National Association of Software and Service Companies (NASSCOM), and was a member of the International Advisory Panel of Malaysia's Multimedia Super Corridor. He was the driving force behind the Hyderabad-based Emergency Management Research Institute (EMRI), and served as Chairman and Member of its Governing Board. He received the Corporate Citizen of the Year award during the Asian Business Leadership Summit held in Hong Kong in 2002. He was also named the IT Man of the Year by Dataquest in 2001, and was conferred the Entrepreneur of the Year Award (Services) by Ernst & Young, India in 2000.

Since its foundation in 1987 Satyam rapidly grew into a four billion dollar enterprise in two decades. In 1991 it became a public limited company

and went for an IPO that was oversubscribed 17 times. In 1999 Satyam Infoway became the first Indian Internet service provider to be listed on NASDAQ, and in 2001 Satyam's ADR was listed on NYSE (SAY). By 2008 it was the fourth largest Indian software and Business Process Outsourcing (BPO) company after giants like Infosys, Tata Consultancy Services (TCS) and Wipro. It had operations in several countries across the world, and had clients like the World Bank and partners like GE, and was selected as the official IT services provider for the FIFA World Cup to be held in 2010 in South Africa, as well as the 2014 World Cup to be held in Brazil. A few months before the scandal, Satyam was awarded the Golden Peacock Global Award for Excellence in Corporate Governance in 2008 by the World Council for Corporate Governance.[1] Previously, the Investor's Relations Global Rankings (IRGR) had rated Satyam as the company with Best Corporate Governance Practices for the years 2006 and 2007. In short on the eve of its crisis, Satyam was one of the brightest jewels in India's corporate crown in every possible way. It had a market capitalisation of 3.98 billion US dollars at the end of November 2008. It was also a zero-debt company with over 1.2 billion dollars in cash reserves.

Part of the reason for Satyam's good reputation was its stellar board. In late 2008 its non-executive directors included leading academics from India and abroad including Prof. Krishna Palepu of Harvard Business School, an authority on corporate governance, Vinod Dham, the inventor of Pentium chips at Intel, and other former top bureaucrats from across India. One could hardly imagine a more competent assemblage of people to steer a corporation.

Trouble started on Dec 16, 2008 when Satyam's board approved the acquisition of 100% of the stake in the privately-held Hyderabad-based Maytas Properties for $1.3 billion, and a 51% stake in the public-listed firm Maytas Infra for $300 million. The two firms represented the Raju family's old construction and property business; Maytas is actually Satyam spelt backwards, and was run by Ramalinga Raju's two sons. The decision came as an even bigger surprise considering that the Rajus had taken Maytas Infra public just a year prior to the acquisition proposal. As

of September 31, 2008, promoters held 36.64% in Maytas Infra. The price to be paid to the promoters was fixed at Rs. 475 per share, 1.25% discount to the closing price of the scrip on Dec 16, 2008. The open offer was to be made at Rs. 525 per share which was a 7% premium to the ruling price as against the 52nd week high of Rs. 946. This would have been a completely unrelated acquisition by Satyam in a sector that was arguably as troubled (if not more) as software given the credit crunch that the market was facing at the time.

The institutional shareholders resisted the deal right from the start. There was stiff opposition at the conference call itself which was made to announce the deal, particularly from FII players like Templeton. The main objections raised were that it was not clear (1) who had done the valuation of Maytas; and (2) why Satyam should move into an unrelated industry already under severe stress. Moreover, Maytas' connection to the Raju family looked like a clear insider deal meant to use shareholder money to bail out Raju's sons. Institutional investors went public with their displeasure and approached the media, and the Satyam ADRs opened 35% lower that morning at NYSE and declined further. With a similar landslide expected in India the next morning, the management rescinded the planned acquisition before the Indian markets opened the next morning, within eight hours of the announcement of the deal. But the damage had been done. On December 17, 2008, the Satyam story made headlines across the Indian media and Satyam shares fell by 30.66% (from Rs. 226.55 to Rs. 157.10) and the Nifty 50 fell by 2.87%. This event provides us with the first instance of a corporate governance shock, related to the ineffectiveness of the board in monitoring the management.

However worse was in store for Satyam and its shareholders. The second and bigger event occurred on the morning of January 7, 2009 (while the markets in India were open) when Ramalinga Raju, Satyam's Chairman, disclosed that the firm has been falsifying its accounts for several years, and that its much vaunted $1.2 billion cash holding was largely non-existent and was the result of a long-drawn accounting fraud involving Satyam's auditors PricewaterhouseCoopers (PwC). Satyam

shares fell by 77.47% (from Rs. 178.65 at opening to Rs. 40.25 at close) on that day, and the Nifty 50 fell by 6.18%. This provides us with the second instance of a corporate governance shock, this time related to accounting fraud and lax auditing.

The December 17, 2008 and the January 7, 2009 events thus provide us with two large, unexpected corporate governance shocks concerning the same company but distinguishable in nature—the first one was a shock about board ineffectiveness while the second was related to issues of transparency and accounting malpractice.

3. Data and Methodology

The data for the analysis in this paper came from the CMIE Prowess database and the Directors' Database created under the initiative of the Bombay Stock Exchange and designed and maintained by Prime Database. The objective of the analysis was to find out which corporate governance variables had an effect in determining the cross-sectional variation in the reaction of Indian companies to the two corporate governance related events discussed in the previous section.

The dependent variable was the individual returns on listed Indian stocks on or after the two critical days—December 17, 2008 and January 7, 2009. We started off by constructing the market adjusted abnormal returns around these two events, and cumulated the abnormal returns over a five day period encompassing the two days before and the two days after each of the two events. The Cumulative Abnormal Returns (CAR) over an event window of ± 2 days around the event date formed the reference variable for our analysis, though arguments could be made in favour of using raw returns as well as abnormal returns on each of the specific event days of the shocks. We used these variables in our robustness checks.

Our computation of the market adjusted abnormal returns followed the standard approach used in event study literature (Barber & Lyon, 1997; Mitchell & Stafford, 2000, among others). We computed the daily returns using the closing prices of two consecutive trading days using the formula

Rt = (Pt – Pt-1)/Pt-1, where Rt stands for the daily returns, Pt represents the closing price for day 1, and Pt-1 represents the closing price for day 2. We used the returns on all the stocks listed at the National Stock Exchange as our starting point, and used the Nifty 50 index to capture the market returns. 250 daily returns ending on November 30, 2008 for each stock and the respective indices were used to estimate the alphas and betas of the individual stocks and hence the expected and abnormal returns on the two days of interest.

After constructing the CAR, we ranked the companies in terms of their CAR (in descending order of CAR) and divided them into three equal groups. We considered the top and the bottom groups, and estimated a Probit model to examine if the probability of belonging to the top group (firms with high CAR) was influenced by a firm's corporate governance characteristics.

The choice of the independent variables was far more open. The literature on corporate governance has dealt with several variables that may individually capture important elements of corporate governance. Since we were looking at a within-country variation, we abstracted from among all the institutional variables that were common to all the stocks used in the analysis. Broadly speaking, we looked at a set of board related variables, a set of variables that captured the ownership patterns, variables that probed into the nature of auditors the firms used, and those that looked at the nature and composition of the audit committee. Our choice of variables was motivated by our a priori expectations of the drivers of the stock reactions—board related variables for the first event which primarily brought focus on the ineffectiveness of the board in restraining the management from pushing through an insider deal, and auditor and audit committee related variables for the second event which pertained mainly to accounting quality. Our choice was also influenced by the regulatory focus in recent years in India (as elsewhere) on the composition of the board and the role of its audit committee in improving corporate governance standards; this would enable us to comment on the extent to which the market views these mechanisms as meaningful and effective institutions of corporate governance in India.

Among the board related variables, we considered board size and board independence as measured by the proportion of independent directors on the board. In addition we probed deeper into the nature of the independence of the independent directors by looking at the tenure of the current independent directors and their age, to assess if the market took these variables into consideration while assessing the true independence of the board. Finally we looked at the accounting knowledge of the directors serving on the board. Using the Prowess database, we identified how many directors had at least a degree in accounting or finance implying knowledge of accounting.

The ownership pattern of the firm in question would be likely to play a role in the nature of its corporate governance as well. Business groups constitute an important category in India with related corporate governance issues. We looked at whether the firm belonged to a business group or was a standalone firm. The share of promoters in the equity of a firm was another potentially important variable.

In addition to the board variables, we paid special attention to the audit committee of the board that is expected to play an important role in determining the reliability of a firm's accounting information. We looked at the proportion of independent directors in the audit committee as well as the extent of accounting knowledge in the audit committee analogous to the corresponding variable at the board level.

Finally, the auditors of a firm play a key role in its corporate governance, and are likely to be particularly important in ensuring faith in the company's financial numbers, which is the critical issue in the second event under consideration. We considered several variables related to the auditors of a company. Given that PricewaterhouseCoopers (Satyam's auditors) was likely to have suffered a loss of reputation following the scam, we used a dummy variable to find out if PwC was an auditor of the company under consideration. The three other audit firms that form the Big Three auditors were also assigned a corresponding dummy variable. A similar variable was constructed for the top six domestic audit firms as well.

Table 1 provides the descriptive statistics of the variables used in the analysis.

Table 1: Descriptive statistics for the two Satyam-related corporate governance events

Event 1: December 17, 2008					
Variables	**Lower Quartile**	**Mean**	**Median**	**Upper Quartile**	**Std Dev**
Board size	5.00	7.06	7.00	9.00	2.50
Board independence (%)	45.45	53.20	50.00	60.00	15.65
Majority board (dummy)	0.00	0.74	1.00	1.00	0.44
Super-majority board (dummy)	0	0.10	0	0	0.30
Average age of independent directors (years)	52.75	58.93	60.00	65.75	9.63
Average tenure of independent directors (years)	4.25	7.75	6.67	10.00	4.56
Average no. of directorships of independent directors	2.00	3.32	2.71	4.00	2.66
Promoters' share ownership (%)	36.93	48.36	50.29	61.39	18.37
FIIs' share ownership (%)	0	4.21	0	4.75	8.29
Mutual funds' share ownership (%)	0	1.87	0.02	1.52	4.01
Banks and financial institutions' share ownership (%)	0	1.92	0.02	1.67	4.23

	Standalone Companies			Group Companies			All Companies		
	Abnormal Return on Dec 17 vis-à-vis Nifty 50	5-day CAR vis-à-vis Nifty 50	Return on Dec 17	Abnormal Return on Dec 17 vis-à-vis Nifty 50	5-day CAR vis-à-vis Nifty 50	Return on Dec 17	Abnormal Return on Dec 17 vis-à-vis Nifty 50	5-day CAR vis-à-vis Nifty 50	Return on Dec 17
5th percentile	-0.9871	-0.1269	-0.0863	-0.082	-0.1219	-0.0943	-0.1214	-0.1248	-0.09
10th percentile	-0.069	-0.0955	-0.0622	-0.0582	-0.0899	-0.0718	-0.0633	-0.093	-0.0675
First quartile	-0.0326	-0.0447	-0.0425	-0.0309	-0.0508	-0.0486	-0.032	-0.0472	-0.046
Mean	-0.0523	0.0152	-0.0094	-0.0268	-0.0022	-0.0202	-0.0415	0.0079	-0.014
Median	0.002	0.0099	-0.0071	-0.0043	-0.0072	-0.0226	-0.0013	0.0025	-0.0141
Third quartile	0.0341	0.0694	0.0188	0.0214	0.0356	0.0046	0.0306	0.0555	0.0128
90th percentile	0.061	0.1361	0.049	0.0565	0.0975	0.0411	0.0589	0.1206	0.0484
95th percentile	0.0702	0.1895	0.05	0.065	0.1379	0.0494	0.0684	0.1706	0.0499
No. of observations	965	952	952	703	699	699	1668	1651	1651

Event 2: January 7, 2009					
Variables	**Lower Quartile**	**Mean**	**Median**	**Upper Quartile**	**Std Dev**
Size of audit committee	3.00	2.99	3.00	3.00	1.02
Audit committee independence (%)	66.67	78.58	75.00	100.00	23.21
Fully independent audit committee (dummy)	0.00	0.34	0.00	1.00	0.47
Average age of independent directors on audit committee (years)	38.33	47.46	48.00	59.00	16.36
Average tenure of independent directors on audit committee (years)	3.25	6.64	5.50	9.00	4.65
Average no. of directorships of independent directors on audit committee	2.00	2.90	2.33	3.50	2.56
Financial expert on audit committee (dummy)	0.00	0.63	1.00	1.00	0.48
Financial expert on board (dummy)	1.00	0.91	1.00	1.00	0.29
PricewaterhouseCoopers (dummy)	0.00	0.03	0.00	0.00	0.18

	Standalone Companies			**Group Companies**			**All Companies**		
	Abnormal Return on Jan 7 vis-à-vis Nifty 50	5-day CAR vis-à-vis Nifty 50	Return on Jan 7	Abnormal Return on Jan 7 vis-à-vis Nifty 50	5-day CAR vis-à-vis Nifty 50	Return on Jan 7	Abnormal Return on Jan 7 vis-à-vis Nifty 50	5-day CAR vis-à-vis Nifty 50	Return on Jan 7
5th percentile	-0.9908	-0.1594	-0.1417	-0.1227	-0.1534	-0.1405	-0.9748	-0.1584	-0.1415
10th percentile	-0.1106	-0.1413	-0.1135	-0.0833	-0.1212	-0.1183	-0.1005	-0.1357	-0.1159
First quartile	-0.0603	-0.0772	-0.0835	-0.0582	-0.0691	-0.0906	-0.0587	-0.0711	-0.0874
Mean	-0.089	-0.0095	-0.0464	-0.0573	-0.0161	-0.0588	-0.0758	-0.0122	-0.0516
Median	-0.0263	-0.0109	-0.048	-0.0272	-0.0174	-0.0522	-0.0267	-0.0131	-0.0491
Third quartile	0.0044	0.0559	-0.0057	-0.0012	0.0444	-0.0266	0.0024	0.0497	-0.0155
90th percentile	0.0459	0.1044	0.0207	0.03	0.0901	0	0.0382	0.0986	0.0097
95th percentile	0.0622	0.152	0.0476	0.0508	0.1143	0.0222	0.0578	0.1372	0.0417
No. of bservations	997	984	984	711	707	707	1708	1691	1691

4. Results

Event 1: December 17, 2008

The results of the Probit regression for the December 17, 2008 event are presented in Table 2. The companies were ordered in terms of their CAR (companies with highest CAR being at the top), and were divided into three equal groups. The top and the bottom groups were used to estimate a Probit model to examine how the probability of belonging to the top group (firms with high CAR) was influenced by a firm's corporate

governance characteristics. The regressions considered various board-related variables as independent variables after adjusting for leverage and industry controls for 21 industries. The rationale for this was that the December 16, 2008 board meeting of Satyam, where its acquisition plan for Maytas was approved, and the ensuing uproar among international investors raised doubts—rightly or wrongly—about the ability of boards to protect minority shareholders from promoters. Hence the quality and role of independent directors were likely to be key variables on that day.

Board size featured on our list of variables—evidence from earlier research indicates its importance. Board independence as measured by the proportion of independent variables was another key variable. According to Clause 49 of the Listing Agreement, at least 50% of the board of a company with an Executive Chairman or a Chairman who is a promoter or related to the promoter must comprise independent directors, while at least one-third of the boards of other listed companies should be composed of independent directors.

We probed further into the characteristics of the independent directors to check if the markets assessed their quality and actual independence. We used age as an (imperfect) indicator of experience, and tenure on the board as an indicator of de facto independence, assuming that a longer tenure on a board is likely to compromise a director's independence. Finally we looked at another measure of board quality—the average number of directorships held by the independent board members. It was difficult to sign this variable a priori. Prior research suggests that the number of board seats held by directors can point both to their quality as well as their busyness, indicating a positive and a negative effect respectively on quality.

Finally we looked at a set of ownership variables. Promoter's share came first in this list as prior research indicates that a high level of promoter ownership can act as a bonding device with outside shareholders to signal the commitment of owners to maximise shareholder value and not engage in the expropriation of minority shareholders. Institutional ownership featured next, which was classified according to institution type. Foreign

Institutional Investors (FIIs), mutual funds, and banks and financial institutions form the three different categories of institutional investors.

Given that the December 2008 event centred around fears that minority shareholders' funds were being tunnelled by promoters through transfers to other group companies, we also ran our regressions separately for the two subsets—standalone firms and group firms—within our sample.

Table 2 presents our results for the full sample as well as the sub-samples. The values in parentheses are p-values computed using heteroscedasticity-consistent standard errors.

Table 2: Regression results for the Satyam-related December 17, 2008 event

Variables	All Companies			Standalone Companies			Group Companies		
	Estimate	Standard Error	Pr > ChiSq	Estimate	Standard Error	Pr > ChiSq	Estimate	Standard Error	Pr > ChiSq
Intercept	-0.1383	0.4411	0.7538	0.0806	0.5288	0.8788	-0.6872	0.9146	0.4525
Board size	0.0574	0.0290	0.0479**	0.0508	0.0382	0.1833	0.0685	0.0455	0.1326
Super-majority board	0.4296	0.2216	0.0526**	0.6513	0.2920	0.0257**	0.1547	0.3530	0.6612
Mean age of independent directors on the board	-0.0030	0.0084	0.7174	-0.0075	0.0104	0.4680	0.0065	0.0153	0.6702
Mean tenure of independent directors on the board	0.0498	0.0157	0.0015***	0.0432	0.0220	0.0496**	0.0436	0.0238	0.0670*
Promoters' share ownership	0.0262	0.0040	<.0001***	0.0292	0.0051	<.0001***	0.0199	0.0069	0.0039***
Mean no. of directorships of independent directors on the board	0.0345	0.0465	0.4575	0.1625	0.0751	0.0305**	-0.0990	0.0673	0.1411
Group company	-0.2422	0.1408	0.0854*						
FIIs' share ownership	-0.0139	0.0104	0.1815	-0.0206	0.0149	0.1680	-0.0089	0.0150	0.5550
Mutual funds' share ownership	-0.0085	0.0172	0.6224	-0.0132	0.0235	0.5760	-0.0076	0.0265	0.7743
Banks and financial institutions' share ownership	0.0646	0.0162	<.0001***	0.0992	0.0250	<.0001***	0.0341	0.0211	0.1052*
Log of total assets	-0.3412	0.0533	<.0001***	-0.3961	0.0703	<.0001***	-0.2697	0.0875	0.0021***
Debt-equity ratio	-0.0065	0.0122	0.5934	-0.0093	0.0276	0.7352	-0.0070	0.0138	0.6098
-2 Log L	1465.002			892.135			556.669		
No. of observations	1176			742			434		

***, **, * denote coefficients significant at the 1%, 5%, and 10% level, respectively.

Findings

The regression indicates several key findings.

The results indicate that board size does matter—companies with bigger boards did better. This supports the recommendation made in the Naresh Chandra Committee report that the minimum size of the board should be seven. 48% of the companies in our sample had board sizes that were less than seven. This does not mean that unusually bigger boards will do better. The 95th percentile value in our sample is 12, which is consistent with the Companies Bill stipulation that board size be capped at 12.

Companies with super-majority boards (composed of 75% or more independent directors) experienced higher CAR. In separate regressions that have not been reported here, majority board turned out to be insignificant. The market seems to give credence to independent directors only when they have substantial voice.

The value for the tenure variable is positive suggesting that the positive effects of directors' experience outweigh the negative effects of entrenchment and loss of independence from the threat of familiarity associated with long tenures.

The market reaction seemed to in favour of companies with higher promoter share, perhaps due to the notion of commitment. Note that the promoters slowly divested their share ownership in Satyam over time, and by the time the scandal occurred they had divested almost their entire equity ownership.

The market penalised group companies. After all the controls, group companies fared significantly worse in CAR.

When we looked at group and standalone companies separately most of the significance of board related variables disappeared. This could be an artefact of the problem of selecting independent directors in group companies—powerful promoters may choose "independent" directors (who are then no longer independent). This could happen in standalone companies as well, but the promoters of group companies could also appoint the same person as an independent director in multiple companies

within the group. Thus the cost of dissent by independent directors is likely to be more in group companies.

The market seemed to reward the skill of independent directors (proxied by total number of directorships) but only in standalone companies, and not in group companies. Similar results have been reported by other research studies on the Indian situation.

The overall take away from the analysis of the December 17, 2008 event is that while board independence matters, the competence and expertise of the board are perhaps more important. However, promoter dominance may weaken the effectiveness of board independence. These findings suggest that measures to strengthen board independence by mandating the creation of a nomination committee, defining independence properly and unambiguously, and setting up an effective process for the functioning of the board—by having the independent directors meet without the interference of the management for instance—may be helpful.

Our findings corroborate the relatively mixed evidence found in the empirical literature regarding board independence and firm performance. While some of these studies find that boards which are more independent have a beneficial effect on firm performance (Dahya & McConnell, 2003), and on discrete tasks such as the hiring and firing of chief executive officers (Weisbach, 1988), and hostile takeovers (Brickley et al., 1994), a significant number of studies report results to the contrary (Bhagat & Black, 2002; Hermalin & Weisbach, 1991). Some of the studies in the Indian context seem to suggest that more than board independence, factors like the quality of the board as captured in terms of the expertise and diligence of the independent directors (beneficial effect), CEO duality (adverse effect), and the presence of controlling shareholders on the board (adverse effect) matter more in corporate governance (Sarkar et al., 2008; Sarkar & Sarkar, 2009). Similar views are also expressed in reviews of corporate governance practices based on company surveys (FICCI-Grant Thornton, 2009).

Event 2: January 7, 2009

The January 2009 event was of a distinctly different nature when

compared to the December 2008 event even though it was related to a corporate governance issue involving the same company. In the second event, the issue was the failure of auditing and the doubt it cast on accounting information about Indian firms, large and small, across the board.

Consequently the independent variables used were different from the preceding analysis. We focused on the nature of the auditor, and the characteristics of the audit committee together with leverage, ownership variables, and the industry controls used for the first event. We used a dummy to capture the effect, if any, of having PricewaterhouseCoopers as an auditor. For the audit committee, we used variables for board size, independence (proportion of independent directors), mean age, and tenure of audit committee members that were analogous to those used in the regression for the first event. Next we took into consideration the accounting expertise of directors constituting the audit committee. Using the information provided by the Directors' Database on the educational background of individual directors we calculated the number and the proportion of the audit committee members who had an accounting, banking, or management degree which we assumed indicated knowledge of accounting. While this was certainly an imperfect indicator of expertise in that it missed out on the vast experience many people gain by dealing with accounting at work and instead cast faith in certain academic degrees (perhaps more than they deserved), it was a close objective measure for what we were trying to capture—the ability of the committee to interact with the auditors and to pick up accounting errors, if any. We used dummy variables—one for the board and one for the committee—to verify if at least one director serving in it had the necessary expertise.

Table 3 reports the results of this regression analysis for the full sample as well as for the standalone and group firms sub-samples. As in Table 2, the values in parentheses are p-values computed using heteroscedasticity-consistent standard errors. The companies were ordered in terms of their CAR, and were divided into three equal groups. The top and the bottom groups were used to estimate a Probit model to examine how the probability of belonging to the top group was influenced by the

firm's corporate governance characteristics. We report the results using the audit committee dummy for financial expertise; the results are invariant if we use the board dummy instead.

Table 3: Regression results for the January 7, 2009 Satyam-related event

Variables	All Companies			Standalone Companies			Group Companies		
	Estimate	Standard Error	Pr > ChiSq	Estimate	Standard Error	Pr > ChiSq	Estimate	Standard Error	Pr > ChiSq
Intercept	0.1818	0.5596	0.7453	0.5630	0.7392	0.4463	-0.8565	1.0096	0.3963
Audit committee size	0.0554	0.0849	0.5142	-0.0072	0.1101	0.9477	0.1214	0.1415	0.3908
Independent audit committee	0.2680	0.5579	0.6310	-0.0615	0.7280	0.9326	0.9968	0.9889	0.3135
Mean age of independent directors on the audit committee	-0.0072	0.0062	0.2425	0.0001	0.0078	0.9946	-0.0178	0.0108	0.0995*
Mean tenure of independent directors on the audit committee	0.0110	0.0191	0.5664	-0.0240	0.0270	0.3747	0.0524	0.0283	0.0638*
Promoters' share ownership	0.0092	0.0041	0.0255**	0.0040	0.0051	0.4299	0.0218	0.0079	0.0060***
Mean no. of directorships of independent directors on the audit committee	0.1148	0.0548	0.0360**	0.0278	0.0779	0.7209	0.2006	0.079	0.0111***
Audit committee has financial expertise	0.1218	0.1747	0.4856	0.1423	0.2189	0.5158	-0.0092	0.3044	0.9759
Pricewaterhouse Coopers	-0.0658	0.3662	0.8575	0.2858	0.6345	0.6524	-0.2615	0.4917	0.5948
Group company	-0.4295	0.1519	0.0047***						
FIIs' share ownership	0.0214	0.0099	0.0308**	-0.0093	0.0129	0.4715	0.0744	0.0173	<.0001***
Mutual funds' share ownership	-0.0263	0.0180	0.1434	-0.0527	0.0253	0.0375**	0.0017	0.0269	0.9506
Banks and financial institutions' share ownership	0.0238	0.0174	0.1724	0.0131	0.0248	0.5969	0.0481	0.0267	0.0723*
Log of total assets	-0.1977	0.0521	0.0001***	-0.0850	0.0649	0.1906	-0.4120	0.0949	<.0001***
Debt-equity ratio	0.0057	0.0087	0.5124	0.0084	0.0120	0.4852	0.0066	0.0156	0.6744
-2 Log L	1228.254			754.181			443.907		
No. of observations	916			560			356		

***, **, * denote coefficients significant at the 1%, 5%, and 10% level, respectively.

Findings

The major findings of the regression analysis shown in Table 3 are summarised below.

The results show that group companies were severely punished. The coefficient of the January 2009 event (-0.4295) was almost double that of the December 2008 episode (-0.2422). This was expected as the January episode was related to basic accounting propriety—the accounting numbers could no longer be trusted. The problems were likely to be exacerbated for group companies for whom prior research has shown the existence of expropriation of minority shareholders through tunnelling, related party transactions, and earnings management.

Promoter share remains positive and significant, suggesting the importance of commitment.

The PricewaterhouseCoopers dummy was found to be insignificant. The market did not seem to penalise companies for their PwC association. Traditionally, accountants have had the responsibility of verifying the quality of income statements, and quality can be inferred only on the basis of deviations from the benchmarks. In the case of Satyam, the accounting fraud was based on well-planned, systematic doctoring of the entire accounting chain, altering the benchmark itself. The market seems to have given the benefit of doubt to PwC as a firm, concluding that it was no worse than its peers in the trade.

Foreign institutional ownership continued to show a strong positive signalling effect on firm quality, except for the sub-sample of standalone firms.

Independence of the audit committee did not seem to matter for this particular event. Audit committee quality (experience as proxied by tenure, and expertise as proxied by total directorships of members) seemed to matter (surprisingly perhaps) only for group companies. It would appear that in the January 2009 episode, the market reacted only to group companies and variations among these. Concepts like related party transactions and tunnelling are far less applicable to standalone

companies. The presence of a director with financial expertise in the audit committee did not seem to matter either. Though the current Clause 49 regulations require all members of the audit committee to be "financially literate", with at least one member having "accounting or related financial management expertise", the definition of financial literacy—"the ability to read and understand basic financial statements"—is perhaps too weak to send any effective signal to the market about the financial qualification of the audit committee.[2]

We found that audit committee independence and audit committee financial expertise were relatively unimportant for the second event. This differs from the expectations created by the empirical evidence provided in the extant literature which shows that independent audit committees lead to higher earnings and audit quality (Klein, 2002; Carcello et al., 2002), and such effects are strengthened by the presence of independent directors in the audit committee with corporate or financial background (Xie et al., 2003; Yeh & Woidtke, 2007).

5. Conclusions

We analysed the cross-sectional variation in individual stock returns in India on two specific days when the market was hit by news of significant (and unanticipated) corporate governance failure in a major Indian company which made national headlines for a long time. We investigated whether the variation could be explained by the corporate governance variables frequently mentioned in the extant literature particularly those related to the board, ownership patterns, and auditor/audit committee variables. These are also generally the measures that the Indian stock market regulator SEBI, like its peers elsewhere in the world, has focused on in bringing about corporate governance reforms in recent years.

We found that in the first instance related to a shock about board effectiveness, firms with mid to large boards did better in the market. As for independence, a super-majority (three-quarters or more) of independent directors mattered, but a simple majority did not. The average board

tenure of a director had a positive, not negative, effect, suggesting that experience beats familiarity in the market's perception. Higher promoter share appeared to instil confidence, as did size.

For the second episode which signalled an audit failure, neither the size nor the independence of the audit committee seemed to matter. Promoter and FII holdings had a positive impact on the entire sample as well as for group firms. Size had similar effects as well. Interestingly, PricewaterhouseCoopers did not seem to carry a stigma that affected its clients significantly.

In both the cases, a group association seemed to flag greater concerns for the market, markedly more so with the audit related shock than with the board related shock.

This paper provides a first-cut analysis of the impact of corporate governance perception shocks on different firms. Our findings seem to suggest that the market's perception of corporate governance indicators are not necessarily in complete agreement with the list of usual suspects frequently discussed in the literature and targeted by regulators. It is possible that the ground-level realities of an emerging market environment like India's, and the dynamics of board selection and decision making reduce or modify the manner in which these variables are expected to work in countries which are characterised by arm's length transactions. In particular there seems to be a considerable gap between the market's view and the conventional wisdom regarding the importance of independent directors. The analysis suggests that perhaps more than board and audit independence per se, it is the quality and expertise of the board and the audit committee, and the process of selecting independent directors, and the setting up of an effective board and audit process that are important for effective governance.

A lot of research remains to be done to advance this line of enquiry. Can independent directors provide effective corporate governance in companies with promoter dominance as is typical of many Indian and East Asian corporations? Does their contribution depend on the regulatory

environment that varies across countries? Do big name audit firms provide a remedy for lax accounting and auditing standards? How strong is the effect of the auditor's reputation on a firm's returns? These and many more such issues need to be investigated for a better understanding as well as an effective regulation of firms in emerging markets. The event study methodology adopted here could provide answers to some though not all such questions.

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Notes

[1] The award was withdrawn immediately after details of the scam became public.

[2] See Appendix for details of the Clause 49 regulations.

Appendix

Size and Composition of Audit Committee under Clause 49 Regulations (as per SEBI Circular: SEBI/CFD/DIL/CG/1/2004/12/10 dated October 29, 2004).Clause 49, Section II: Audit Committee

(A) Qualified and independent audit committee

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:

(i) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

(ii) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

Explanation 1: The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

Explanation 2: A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a Chief Executive Officer, Chief Financial Officer, or other senior officer with financial oversight responsibilities.

(iii) The Chairman of the audit committee shall be an independent director;

(iv) The Chairman of the audit committee shall be present at Annual General Meeting to answer shareholder queries;

(v) The audit committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;

(vi) The Company Secretary shall act as the secretary to the committee.

11

Looking for Patterns in Corporate Failures

Pratip Kar

1. Introduction

This paper is about the failure of companies when they are confronted with critical governance matters. According to Christensen (2002), "Companies stumble for many reasons, of course, among them bureaucracy, arrogance, tired executive blood, poor planning, short-term investment horizons, inadequate skills and resources, and just plain bad luck" (p. xi). But this paper is not about the failure of such companies caused by such weaknesses. It is about companies which were regarded as well managed and competitive (perhaps too competitive) till they suddenly failed; companies which were much admired by the stock market, analysts, investors and shareholders, companies which came to be widely acknowledged for their business models, companies which were led by men and women whose examples people were asked to emulate till it was discovered that they had feet of clay. Corporate governance with the trappings of rules, regulations, procedures, legal systems, ethics, culture, and ethos is like a harness which can help drive a company on a sustainable growth path, without which the growth of a company can often become illusively spectacular only to end in business disruption, financial depravation and devastation. We study a few of these companies in order to find patterns which could help to establish a framework for governance.

2. Need to recognise patterns

Recognising patterns and finding order in a chaotic clutter of data is important for businesses. There could be patterns in financial performance, profits, consumer tastes and behaviour, formats of stores or even in supermarkets. Since knowledge and innovation drive today's business more than ever before, good managers are known to study and identify patterns before they take business decisions at the strategic, technical, and operational levels. It enables them to have a better understanding of potential outcomes. The foundation for pattern recognition is data and information, and so they resort to data mining and gather information and search for patterns.

Historically, cognitive anthropologists and naturalists have resorted to identifying patterns from masses of data. Clinical psychology and the behavioural sciences also rely on pattern recognition.

Studies of the more (in)famous corporate frauds in different countries over the years show that governance failures also fall into identifiable patterns. It might be of interest to find out what these patterns are and draw lessons from them, though admittedly, the recurrence of patterns seems to indicate that lessons are not easily learnt whenever there is a specious association of money and ambition. Our studies show that ever so often there are instances of a single deliberate intransigence necessitated by the desire of the management to avert an immediate crisis, that lead to a series of consequential infringements costing the entire corporation dear. We find that boards are often unaware of the infringements, or are deliberately kept unaware by the managements. We find that even when the boards notice these, their first reaction is to ignore the signals, or to treat them as weak signals, followed by attempts to cover up the misdemeanours under the guise of business expediency, or to find convincing justifications. More often than not boards hesitate to question the logic/need driving the action: It has been observed that in such companies, charismatic leadership coexists with cultism and unethical behaviour thrives on internal aggression; there is a facade of team work, behind which lurks a punitive environment; there is an atmosphere of ingratiation stifling critical upward communication.

Because it may be a while before financial results are affected, extant financial results may not reflect the true state of affairs at the company. The sanctity of financial numbers must of course remain paramount. But no amount of rigour or sophistication of the mathematical models can assure the accuracy of the conclusions, if the input numbers themselves are wrong, a truth that is so often lost on those who reach conclusions by crunching numbers alone.

3. The march of folly

Tuchman (1984) describes folly as “the pursuit of policy contrary to the self-interest of the constituency or state involved...folly is a policy that is counter-productive” (p. 5). To count as folly, the acts must necessarily have four attributes— these must be clearly contrary to the self-interest of the organisation or group pursuing them; these should be committed over a period of time, not just in a single burst of irrational behaviour; these should be conducted by a number of individuals, not just one deranged maniac; and there must be people alive at the time who correctly pointed out why the act in was folly.

In those companies where the lack of adherence to the principles of corporate governance resulted in an apocalyptic collapse, some common patterns are visible in the following areas—the genesis of the company itself; the ideas, ambitions, and personal dreams of the person(s) who sets up the business; the business model itself; the course of the business and its growth; the board composition, design, and the manner of its functioning; the internal management processes and controls; the overzealous reaction of the rest of the world to the initial success; the behaviour and aggressive culture of the organisation; the external connectivity, reliance on high connections and political support; the sudden discovery of what is actually going on; the speed of the collapse; the consequences of the collapse; and the extreme response of the external regulators in the wake of the collapse to the prevent recurrence.

We now turn to a review of three instances in this march of corporate folly—Maxwell, Parmalat, and Enron. We follow up with a few others

as well, although very briefly. A common feature in all these would be an initial intense phase of euphoria, “a mass escape from reality, that excludes any serious contemplation of the true nature of what is taking place” (Galbraith, 1994), followed by a spectacular collapse. The global financial crisis of 2008 is another classic example of this phenomenon.

The fall of Maxwell Corporation

The fall of Maxwell Corporation is integral to this discussion because it triggered the genesis of a regulatory framework of Corporate Governance in the UK and Europe, serving as a reference point for corporate governance for the rest of the world.

In November 1990, the body of Robert Maxwell, the British media magnate was discovered in a luxury yacht floating in the waters around Canary Islands and in it was. The cause of his death was unknown. Robert Maxwell had rapidly built his media empire in the UK through a series of acquisitions in the 1980s. The acquisitions were highly leveraged and it was found well after his death that the debts were financed by diverting resources from the pension funds of his companies. At the time of his death the total debt of his companies was $5 billion, and £440 million (GBP) were missing from the company’s pension funds.[1] The failure of the Maxwell Corporation prompted the Financial Reporting Council, the London Stock Exchange, and the accountancy profession in the UK to set up a committee in 1991 chaired by Sir Adrian Cadbury to investigate the British corporate governance system, and to suggest ways to restore investor confidence in the system.[2]

Robert Maxwell (born Jan Ludvik Hoch) was the son of a poor Czech Jewish farmer. He fled from Czechoslovakia to the UK to escape extreme poverty and the German repression of the Jews. He changed his name several times and became a naturalised citizen in 1946, when he adopted of the name Robert Maxwell.

His burning ambition to become wealthy, his zealousness and business acumen led him to try out the publishing business. While serving in the British army, he had developed contacts with the Allied forces and

became a distributor for Springer Verlag which he acquired after the Second World War. His next acquisition was Pergamon Press in 1954 which he transformed into a major publisher of scientific journals by 1957 and took it public in 1964. In 1970 Maxwell established the Maxwell Foundation in Liechtenstein. In 1981 he turned the British Printing Corporation into a profitable venture and named it Maxwell Communications Corporation. By 1980 he saw the fulfilment of his ambition, when he became a British media millionaire. Between 1980 and 1990 his multiple acquisitions were funded largely through bank borrowings. He bought and sold companies at a rapid rate, apparently to conceal the unsound foundations of his business. The Mirror Group was acquired; he also bought the interests of the Macmillan Publishing House. Maxwell pioneered the dissemination of highly specialised scientific information, responding to the exponential growth of investment in academic research.

Maxwell held majority stakes in his listed companies, controlling them through a web of private companies established in Liechtenstein and operated by a Swiss lawyer. He used public money through rights issue of Maxwell Communications and floated the Mirror Group to pay off debts, while continuing on an acquisition spree and pledging the same assets multiple times. He manipulated his stocks on the London Stock Exchange to get better valuations and win the confidence of his bankers, and to increase his wealth. He used the best of the bankers—Midland, Lloyds, National Westminster, Barclay's, Sumitomo Trust, Credit Lyonnais, Citicorp and Bankers Trust. His auditors were Coopers & Lybrand and Deloitte, who helped him to clean his books before the year end. His reputation enabled him to fill the board with people of high repute in Britain, who knew very little about his business. The prestigious board of directors, auditors, and bankers gave him and his companies an enviable reputation. He became a Labour Party MP in the House of Commons, serving for 6 years. He was appointed to multiple boards. He had varied interests, one of which was keeping in touch with the totalitarian regimes of Eastern Europe and with Israel, and the other was sports. He bought the Oxford United Football Club with his company's funds saving them from bankruptcy, and goaded

them to the top of English football—they won the League Cup in 1986. He also bought into Derby County Football Club in 1987. It was important for him to have these trappings of power, and he paid enough money to maintain them.

Maxwell's management style was marked by secrecy; he trusted no one—neither his employees, nor his board members. He personally signed all important cheques. His own office and those of his board members were wired, and he tapped the telephone of even his own finance director. His personal life style was flamboyant. The Department of Trade and Industries had become suspicious, and conducted an investigation. Consequently in 1990 he sold Pergamon Press and Maxwell Directories to Elsevier for £440 million partly to cover his debts, but mainly to buy the *New York Daily News;* he also launched an ambitious new project, a transnational weekly newspaper called *The European*.

In 1991, Britain went into recession, and the interest rates rose. Maxwell had substantial borrowings secured on his shareholdings in his public companies, Mirror and Maxwell Communications. The banks were permitted to sell these holdings in certain circumstances, which they did, depressing the share price and reducing the coverage of the remaining debt. Maxwell then used more money—both borrowed and redirected from pension funds and even the daily balances of his businesses—to buy shares on the open market, in an attempt to prop up the price and provide the shares as collateral for further debt (Stiles & Taylor, 1993).

By May 1991 there were reports that the Maxwell companies and pension schemes were failing to meet statutory reporting obligations. Maxwell employees lodged complaints with British and U.S. regulatory agencies about the abuse of Maxwell company pension funds. Soon after that, Robert Maxwell's body was found on his yacht off the Canary Islands.

The empire which Maxwell had built over four decades crumbled in four months. His sons Ian and Kevin were convicted for fraud.

Calisto Tanzi and Parmalat

We now turn our attention to Calisto Tanzi who founded the multinational Italian dairy and food corporation Parmalat SpA. The episode under discussion happened about a decade after the fall of Maxwell Corporation.

In the 1990s Parmalat was the leading global company in the production of Ultra High Temperature milk (UHT). By 2003, it was embroiled in fraud and financial failure, and had filed for the biggest corporate bankruptcy (€14 billion; $20bn; £13bn) in Europe. The US Securities and Exchange Commission filed a suit charging Parmalat with one of the largest and most brazen corporate financial frauds in history. The company was reorganised in 2005, and today Parmalat is a company with a global presence, having major operations in Europe, Latin America, North America, Australia, China and South Africa.[3]

Calisto Tanzi, is a third generation entrepreneur from Parma. Tanzi's grandfather set up a small family shop selling sausage and cheese in a Parma dairy farm. His father began selling milk and cheese from door to door. After his father's death in 1961, Tanzi took over; however the small family business did not satisfy him. He wanted to be the largest milk and dairy product company in the world and to be known as the "Coca Cola of Milk". He also wanted to control the reins of power in Italy, which he did, for more than a decade. By the time Parmalat collapsed in 2003, Calisto Tanzi had become a legendary figure in Italy, viewed as a classic entrepreneur who rose from a small door to door vendor of milk and cheese, and built a world-class company (which was Italy's eighth largest) and a global consumer brand.

Those who knew Calisto Tanzi considered him as a charismatic person, and a steady leader; he was so good at math that he always spotted calculation errors in presentations. Soon after founding Parmalat as a dairy company in 1961, he adopted a new pasteurisation technology that allowed milk to stay fresh for months without refrigeration. Parmalat's distinctive cartons soon became a fixture in stores across Italy, and ultimately conquered Europe and much of the world.

He financed politicians, bailed out fellow industrialists, won a knighthood and seats on bank boards, discovered the power of sports marketing, and plastered the Parmalat name on events from World Cup skiing to Formula One racing, and even courted the mafia. He was a pious Catholic and a generous benefactor who renovated cathedrals. He loved power but seemed modest about his achievements. He didn't smoke, drank little, drove his own Lexus, maintained close relationships with the Christian Democrats and dispensed the equivalent of $2.4 million a year in political donations from a fund earmarked for regulatory fees.

Parmalat's finances were weak at least since the 1980s. Tanzi encouraged the falsification of accounts if it would help to get more debt from the bankers. Between 1961and 1980 Parmalat's business grew, but the slow growth did not satisfy the entrepreneur in Tanzi. Debt was necessary for a more rapid expansion of the company. But as he expanded, he also failed and problems started brewing behind Parmalat's façade of success. He took the help of auditors to hide the losses. In 1987, he spent €130 million on a station called Odeon TV to build Italy's third major network. The project collapsed after three years. To stave off bankruptcy, Tanzi engineered a so-called reverse merger, under which it sold itself to a dormant holding company already listed on the Milan stock exchange. The combined firm then raised about €150 million from outside investors. This enabled Parmalat to go public in 1990, and plug some of the gaps in its accounts; at the time it had a market value of around €300 million.

As early as 1993, Parmalat also began to invent financial transactions to pad its balance sheet. While the company should have posted losses every year from 1990 onwards, it posted profits, masking its problems with a mixture of fictitious transactions and aggressive acquisitions of dairy and other companies in Italy, Brazil, Argentina, Hungary and the US.

Tanzi's forgery was crude and simple to the extent of being offensive and ridiculous. He borrowed money from global banks and justified those loans by inflating Parmalat's revenues through fictitious sales to retailers. The core of the fraud was a system of double billing to Italian supermarkets

and other retail customers. This helped Parmalat create the impression that its accounts receivable were much larger than they really were.

To maintain and grow the already inflated bubble, Tanzi had the support of a band of executives, the best bankers of Europe and the US, and compliant auditors. The executives along with the bankers helped structure a complex financing scheme; through a Delaware company arrangements were made involving offshore companies. The auditors Grant Thornton helped in certifying the important parts of the accounts of Parmalat's business including a fictitious account of €2.8 billion in the Bank of America. The bankers and auditors earned huge commissions. Almost half of Parmalat's total debt went to pay interest, commissions and of that, €2.8 billion went to the banks alone. As many as 300 people at Parmalat knew of this. But if anybody thought there was something wrong, they didn't dare to say so publicly. Tanzi's formidable reputation in Italy and his connections with business, politics and sports enabled him to get the support of persons with high connections for Parmalat's board. This helped Parmalat to maintain its respectability and enhance its aura. The board knew nothing of the internal working; little information was shared with the members, and neither did they ask.

While Parmalat's finances were on the brink of collapse, praise from all quarters did not wane until 2003. The company retained the glitz, the stock market valuations were kept high, and its credit rating was investment grade. Tanzi was regarded as a legend who had single-handedly created Parmalat.

Parmalat's true debts became too big to hide. In 1999, a fake Cuban milk scheme was set up with money transferred to shell companies in the Cayman Islands. It was claimed that the fake company had sold enough powdered milk in one year to feed every family in Cuba. The fictitious assets of the shell companies became enormous (up to $8 billion) and the company had to invent a Cayman Islands-based investment fund to take over some of its fictitious credits. This soon attracted the attention of auditors and Italy's stock market regulator in November 2003. Deloitte,

the other auditor besides Grant Thornton, raised doubts over the financial transactions. It then transpired that cash balance to the tune of a few billion Euros which appeared in the balance sheet did not in fact exist. Within a month, the whole scam imploded. Tanzi and 15 other Parmalat executives were accused of fraudulent accounting and market manipulation, and were sentenced to 10 years' imprisonment.

The rise and fall of Enron

The eponym for corporate governance disaster was not the Maxwell episode or Parmalat SpA, but the bankruptcy of the Texas-based energy company Enron Corporation in November 2001, and the dissolution of Arthur Andersen (the oldest audit and accountancy partnership in the US).[4] It happened immediately following the burst of the dot-com bubble in the US and the crash of the US stock market. It was succeeded by several comparable corporate governance disasters which undermined the very foundations of capitalism.

Enron Corporation was established in 1985 through the merger of Houston Natural Gas and InterNorth, two natural gas pipeline companies. It was founded by Kenneth Lay. The son of a Baptist minister who was also a farmer, Lay dreamt of making it big.

Energy companies had been lobbying with the Congress in the 1980s for deregulation of the energy business. When the policy changed, Lay benefited from it and established the Enron Corporation. The deregulation of electricity made it possible for Enron and other companies to sell energy at higher prices and thrive. While local governments cried against price volatility, Lay used his political connections to keep the free market alive. But Lay was not happy making money only by generating electricity and setting up gas pipelines. Being capital intensive, future cash flows from the company's projects were bound to be slow. Lay wanted to make money quickly. He recruited Jeff Skilling in 1990, who helped transform Enron from a natural-gas pipeline company into an energy-trading powerhouse. It also diversified into other areas like weather, bandwidth, and other derivatives. Enron changed its business model—from power generation

and distribution, to power trader to electricity trader to energy trader, and then to trader in energy derivatives—to make money even faster. Enron began to bet against future movements in the price of gas-generated energy. Enron was said to buy and sell tomorrow's gas at a fixed price today. A major portion of Enron's revenue came from energy trading and not from the pipelines it was laying in Central America or elsewhere.

By 2001, Enron had become a conglomerate that owned and operated gas pipelines, pulp and paper plants, broadband assets, electricity plants, and water plants internationally. When Enron was in the natural gas business, it had straightforward accounting. However Skilling insisted that a trading business should adopt mark-to-market accounting, in order to record true economic value. He used mark-to-market accounting with the approval of the US SEC, and extended it to book revenue on the basis of hypothetical future cash flows. Skilling called it the "hypothetical future value accounting" which was used for all Enron's businesses.

This policy led to a growing mismatch of profits and cash. The accounting policy helped to raise profits, the value of its stock and record ever higher revenue and profitability growth year on year. The stock increased by 56% in 1999 and a further 87% in 2000, compared to a 20% increase and a 10% decline for the index during the same years. By December 31, 2000, Enron's stock was priced at $83.13 and its market capitalisation exceeded $60 billion—70 times earnings and six times book value—an indication of the stock market's high expectations about its future prospects. Enron was regarded as the most innovative company in the US, figured six times in the Fortune 500 list of Most Admired Companies, and was sixth in *Fortune's* Global 500 list in 2000. Public accolades helped sustain the aura which was built around Enron. Enron was meeting Wall Street's expectations.

Executive compensation was high and was paid through bonuses and stock options. So the executives of Enron had an interest in keeping the stock prices high. While the stock prices rose, so did the value of options, and employees, board members and key executives encashed the options in the rising stock market. Enron was able to recruit a group of derivative

traders who were known for their aggression. The aggressive management style and HR practices and performance management system encouraged aggressive behaviour. The new recruits emulated the aggression of Skilling and idolised Lay.

Enron needed money for new investments and acquisitions; besides there was a growing mismatch between cash and profit. Enron resorted to heavy debt, but did not want to show any debt on its balance sheet. In order to hide the debts from its books, it created a web of special purpose vehicles or limited partnerships in tax havens. Some of the more familiar ones were Raptor, Jedi, Chewco, and LJM. The best of the bankers in the US invested in them and Enron entered into complicated structured transactions with these shell companies, which were very little understood by anyone in Enron, except Andrew Fastow, the Chief Financial Officer who managed them, and a handful of investment bankers. But what mattered was that these LPs and structured transactions helped Enron earn revenue and profit and also mask debt on the balance sheet; and what mattered to the market was that Enron's quarterly earnings were growing quarter on quarter.

Enron had the support of a 15-member board of directors which was the envy of corporate America, with only 3 internal directors. Enron also had a risk management system, which was so complicated that no one but Skilling understood it. It also had a code of ethics with the acronym RICE, standing for Respect, Integrity, Commitment and Excellence. However, Lay was not known for his ethical practices. In 1987 at the Enron International Oil Inc. unit in Valhalla there were two rogue traders who incurred $85 million in losses by making risky, disastrous bets. But he allowed the traders to go unpunished because they had earlier helped generate millions of dollars for Enron. The auditing firm Arthur Anderson aided the company by certifying its accounting policies, the structured deals with the shell companies and the marked to market accounting, in return for commissions. When the scandal broke out they also helped to shred the evidence.

Finally the debt was too big to hide and Enron had little cash in business. Realising that Enron was on the verge of collapsing, Jeff Skilling

resigned as CEO on 14 August, 2001, citing personal reasons. He was replaced by Kenneth Lay. By 12 October, 2001 Arthur Andersen, at the prompting of their internal lawyers, began shredding all incriminating documents. On 16 October, 2001 Enron announced writing down of quarterly earnings of $393 million. On 22 October, 2001 the US Securities and Exchange Commission opened inquiries into a potential conflict of interest between Enron, its directors, and its special partnerships. On 8 November, 2001 Enron restated its financials for the previous four years to consolidate partnership arrangements retroactively. The earnings from 1997 to 2000 declined by $591 million, and the debt for 2000 increased by $658 million. The stock price fell rapidly to 1 penny and on 2 December, 2001 Enron filed for bankruptcy in New York.[5]

The enormity of the scandal necessitated the involvement of the US Congress. Besides the investigations by SEC, the Congress began an extensive hearing. At the end of the investigations, all the officials involved were convicted. Fastow and his wife, Lea pleaded guilty to charges of fraud, money laundering, insider trading, and conspiracy. Fastow was sentenced to ten years in prison. Lea was sentenced to one year in prison for helping her husband. Skilling was convicted and sentenced to 24 years and 4 months in prison. Lay faced a total sentence of up to 45 years in prison, but died on July 5, 2006. Arthur Anderson closed down, resulting in the loss of 85,000 jobs. Enron's shareholders lost $74 billion in the four years before the company's bankruptcy, and more than 20,000 jobs were lost.

Between December 2001 and April 2002, the US Senate Committee on Banking, Housing, and Urban Affairs, and the House Committee on Financial Services held numerous hearings about the collapse of Enron and related accounting and investor protection issues. These hearings and the corporate scandals that followed Enron[6] led to the passage of the Sarbanes-Oxley Act on July 30, 2002. The end result of all these corporate scandals was increased supervision, greater emphasis on risk management, stringent disclosures, limitations on the accounting and consultancy linked audit firms, greater responsibilities on the chief executives, and expensive compliance.

Others who also marched

In 1980, 16 year-old Barry Minkow started a small, door-to-door carpet cleaning operation ZZZZ Best in his parents' garage. But the business was too small for his satisfaction. He then set up an insurance restoration business, and a ponzi scheme in 1980. ZZZZ Best experienced explosive growth in both revenues and profits during the initial years of its existence. From 1984 to 1987, the company's net income surged from less than $200,000 to more than $5 million on revenues of $50 million. Minkow lured investors through bank borrowing, forgery, theft, and the ponzi scheme. The media was in love with the "wonder boy" (Akst, 1990). When ZZZZ Best went public in 1986, Minkow and several of his close associates became multimillionaires overnight.

Minkow had next to no problems from his board as they were not very vigilant and attended few meetings. As suggested by his network of friends he had retained Ernst & Whinney as auditing partners. They helped him with the accounts and also gave him the respectability he required.

The fraud was found out in 1987, within a year of the public issue. Minkow was eventually convicted of fraud and sentenced to 25 years in prison following US SEC's investigation.

MicroStrategy was a business intelligence, enterprise reporting, and on-line analytical processing software vendor, founded in 1989 by Michael Saylor, Sanjeev Bansal, and Thomas Spahr. It became a NASDAQ listed company in 1998. Its product line rapidly advanced, its profitability grew rapidly and it caught the attention of the market and the analysts.[7]

In January 1999, the company announced a 93% rise in the revenues. The company notified the SEC of plans to sell a new issue of stock, including up to 1.9 million shares owned by Saylor. Four days later the stock price hit a peak of $333, more than 80 times the price when the company went public in 1998.

However, MicroStrategy was engaging in complicated accounting transactions which allowed top executives to refrain from signing

major contracts until after the end of each quarter, after which they would sign enough of them to allow the company to meet revenue targets, while delaying the others for use in future quarters. The auditors PricewaterhouseCoopers approved these before they reversed course. This allowed the company to book higher revenues and higher profit. The national office of PricewaterhouseCoopers learned of these dubious accounting practices from criticisms of the company's accounting in some complicated transactions in *Forbes* magazine. The company was forced to restate its books, and the profits disappeared. Saylor along with two other officials were accused by the SEC of fraud in reporting profits when the company was actually losing money.[8]

Satyam Computers followed in the footsteps of all these organisations in the march of folly. Satyam was one of the four big software companies in India along with Infosys, TCS and Wipro. Its profitability was rising. It had a wonderful code of ethics. The stock market analysts prized the stock. The company got a number of awards; its founder Ramalinga Raju (who was from a family of farmers) won awards for best corporate governance. Its nine-member board was packed with men and women who were very well respected academicians and industry experts. The auditors were PricewaterhouseCoopers.

Though Raju's main business was software, he always had a preference for property and real estate. He set up two property and infrastructure companies—Maytas Infrastructure and Maytas Properties. The former was listed and the latter remained unlisted. Ramalinga Raju's two sons were the CEO and Vice Chairman of the two companies.

On December 16, 2008, Satyam's Board discussed a proposal for buying out the two Maytas companies as good investment decision to diversify using Satyam's cash. The cost of the deal was $1.6 billion. The independent directors of the board unanimously favoured the decision. The Board was only concerned with the valuation aspect but the issues of conflict of interest or corporate governance did not seem to unduly concern them, even though Satyam's funds were to go to the Raju family.

When the news broke out, the stock market reacted badly and the share prices fell forcing Ramalinga Raju and the Satyam board to reverse and withdraw the deal. The institutional investors and the media raised concerns of corporate governance. Raju came under pressure and disclosed that audited financials over the years had reported inflated revenues and assets, understated liabilities and the substantial reported cash of Rs. 50400 million shown in the balance sheet did not actually exist. PricewaterhouseCoopers distanced themselves and stated that the accounts could not be relied upon. The Government of India and regulators stepped in quickly. The board was dismissed, and a new board was appointed by the government. Ramalinga Raju along with a few key executives of the company and the auditing firm were arrested. The criminal and other litigations have not yet been fully heard or completed.

Quick action by the government and good crisis leadership and management by the new board of directors helped the company to survive the initial shocks. It was bought over by Tech Mahindra of the Mahindra group, and has been renamed Mahindra Satyam.

4. Patterns in folly

The examples in this march of folly have invariably followed a sequence which led these companies and their boards down the slippery slope to their doom. The principal protagonists were those who were the promoters of the companies. They gave shape to companies through their ideas, were instrumental in their rise, and ultimately were the reasons for the downfall of their companies. Thus they are in many ways similar to the protagonists in Greek tragedies who were brought down by a *tragic flaw (hamartia* in Aristotelian terms).

The pattern that emerges from the study of these various corporate frauds has the following sequence.

(1) At the beginning of the march, there is a new company or an existing business operating with an initial business model which is sound, but promises low growth. But low growth is unsatisfying.

(2) The company seeks rapid growth and quick rise in profitability. The company finds that changing the business model or strategy may help, so the business model is changed in search of a higher growth trajectory.

(3) Acquisitions and mergers bring faster inorganic growth, so the company gets involved in acquisitions for more rapid growth.

(4) But rapid inorganic growth requires high level of financial leverage. Banks help, more assets are collateralised, and the borrowings increase.

(5) However, higher growth is not enough; profitability must increase.

(6) The continuous growth and profitability bring recognition to the company and its leadership.

(7) There is an emphasis on the bottom line, a compelling urge for better quarterly results. The need to always beat the main street and to seek approbation of the analysts and the media as a validation of its success becomes a compulsive obsession.

(8) When there is high growth and high profitability, executives are rewarded; executive compensation increases, much of which is paid in stocks. The executives have an interest in the buoyancy of stock prices. Good times bring in public plaudits. The company and its management get rewards.

(9) The Chairman, the CEO and the CFO become heroes.

(10) The spectacular growth is never questioned. It gives the board a sense of unerring infallibility leading to complacency, and inculcates a sense of invincibility in the company's management which in turn translates into an aggressive and cult-like leadership style in the company.

(11) The leadership style silences the potential critics and whistleblowers within the company. The flow of information

to the board is weak. The board does not read or interpret weak signals.

(12) The halo built around the company and its CEO help to attract respectable names onto to the board as independent directors.

(13) However, board members are not enough; good auditors are needed to give credibility to the accounting numbers. So the best among auditors are appointed. They are compliant and accommodative. In return they get lucrative assignments. When continuous growth and quarter on quarter increase in profitability are no longer possible, these auditors either actively help with creative accounting or turn a blind eye to anything unacceptable; their reputation helps to brush aside any criticism of (or challenge to) their certification.

(14) A complacent and somnolent board, and compliant and friendly auditors make a good cocktail. Public accolades and praise from the analysts make the cocktail headier.

(15) But rapid inorganic growth and high level of leverage assumes availability of unlimited liquidity. Higher leverage strains the financial condition of the company and results in an unstable equilibrium, but assures growth as long as the macro economic conditions remain buoyant.

(16) Unfortunately sustenance of macroeconomic buoyancy cannot always be guaranteed. It is a function of multiple factors and externalities over which the company and its executives have little control.

(17) Then there is an unexpected external economic shock, often a high impact, hard to predict event in the domestic or global macro economy; the fragile financial equilibrium is threatened. The company is unable to service its financial obligations.

(18) Efforts are first made by the management and the chief executives not to acknowledge the problem. The complacent board hears nothing, sees nothing, and says nothing.

(19) But then the problem becomes too big to hide. Financial and accounting fraud is discovered.

(20) The end then comes very quickly. The company declares bankruptcy or a new owner takes over.

(21) The regulators and the justice system gear into action. The guilty are penalised. New laws are made to plug all conceivable loopholes. The laws are harsh, and compliance expensive.

Such companies are usually set up by individuals with an entrepreneurial spirit who hail from humble backgrounds, but harbour soaring ambitions to grow fast and be rich. They are intelligent. They understand business, but are always unsatisfied and seek more. Their business strategies and their lives are guided by their *hubris*. They often have an opulent lifestyle and their management styles are oppressive and aggressive. They have scant regard for governance, but pretend to do so. They love to build empires, and seek to build connections with political powers, and nurture the symbiotic relationship between business and politics which help them to survive and unjustly prosper. They resort to tunnelling of funds to help families and friends. But in the end when trouble brews, they are deserted by politicians, and the political system pulls all stops to insulate itself from the consequences of the fallout.

In sum

The disquisition shows how circumstances (across countries and time) have followed certain patterns which first gave the stock market and the institutions associated with it (the shareholders, the media, and the analysts) an illusion of wealth creation and protected that illusion, only to descend into financial dementia and depravity. Exercise of leverage and risky investment, compulsive obsession with profits, connivance of the Chairman, the CEO and the CFO, compounded by a merely ceremonial board, overwhelming public applause, courtship with high connections and display of opulence, pomp and show, together with the hubris of the individuals associated with the companies are the five major contributories in this fairly uniform pattern. These five circumstances also throw powerful

signals for the company boards, especially their non-aligned directors, institutional shareholders, other stakeholders, media and the society at large to sit up and take notice. When they fail to interpret these signals correctly and in time, the affected constituents of the society end up picking up the costs, which can be very substantial. Success in sustainable wealth creation has visited those companies and those boards who have heeded these signals well.

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Notes

[1] For more details, see Arcot and Bruno (2005), Miranda (2001), among others.

[2] The Cadbury Committee Report embodied a set of recommendations which was accepted as the UK Code of Corporate Governance and became applicable to all listed companies on the London Stock Exchange reporting their accounts after 30 June, 1993. Subsequently several committees were set up to refine the code and the monitoring and compliance systems. The present code is the Combined Code of Corporate Governance.

[3] For more details, see Di Castri and Francesco (2005).

[4] See Munson (2005).

[5] For details, see Healy and Palepu (2003).

[6] The scandals involving World Com, Global Crossing, Adelphia and Tyco Global occurred soon after the Enron scandal.

[7] For more details, see "Saylor's Soldiers", Washington Business Journal (17 March, 2006).

[8] These are not the only instances of fraud in recent corporate history. We have used these as examples to show that a pattern exists in the march of folly. Other notable incidents would include the fraud at MiniScibe (the Denver based disk storage products manufacturer), the collapse of Barings Bank in the UK, among others.

12

Integrating CSR into the Corporate Governance Framework: The Current State of Indian Law and Signposts for the Way Ahead

Richa Gautam

1. Introduction

Traditionally, the role of the corporate[1] was clear—with its roots in agency principles, a corporate's responsibility lay towards its principals. Its only responsibility towards stakeholders other than its principals was what society had established through various environmental, labour, and other societal-protection legislations. In today's world however, corporates (for reasons ranging from the business case to philanthropic considerations) are recognising a responsibility to stakeholders that goes beyond their legal responsibilities. As corporates increasingly recognise and act upon this corporate social responsibility (CSR), policy-makers are also searching for innovative ways in which corporates can contribute to a country's sustainable development agenda. One such example is the incentive structure of CSR credits mooted in 2010 by Salman Khurshid, India's Minister of Corporate Affairs.[2]

This paper seeks to examine the nature of CSR in India, and the legal framework best suited for the integration of certain aspects of CSR into corporate policies and practices, and also seeks to explore how corporates and policy-makers can (in light of existing laws) integrate certain elements of CSR into the legal framework of corporate governance.

2. Defining corporate social responsibility

An issue that has prevented CSR from attaining the status of a concrete discipline is the fact that definitions of CSR[3] abound and remain somewhat agenda-driven, shaped by the context and objectives of those defining it. While concepts such as the Triple Bottom Line (Elkington, 1997), and CSR standards that set forth indicators of economic, social, and environmental criteria of operations have gained popularity, no single definition has gained universal acceptance. Too often CSR is defined for the purposes of a specific organisation, country, or group of stakeholders (e.g. investors) in terms of mission statements, or CSR standards, or other voluntary instruments.

International CSR standards and instruments seek to identify the boundaries of what constitutes CSR. The United Nations' Global Compact is a classic example; the details of the ten principles are given in Box 1. Another is the draft of the ISO 26000 Standard on Social Responsibility of the International Organization for Standardization (ISO), which is among the most comprehensive documents to set the contours of a corporate's responsibility towards a range of stakeholders including the environment, labour, consumers, and the community.[4]

Box 1: Ten principles of the UN Global Compact

Human Rights
- Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and
- Principle 2: make sure that they are not complicit in human rights abuses.

Labour Standards
- Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
- Principle 4: the elimination of all forms of forced and compulsory labour;
- Principle 5: the effective abolition of child labour; and
- Principle 6: the elimination of discrimination in respect of employment and occupation.

Environment
- Principle 7: Businesses should support a precautionary approach to environmental challenges;
- Principle 8: undertake initiatives to promote greater environmental responsibility; and
- Principle 9: encourage the development and diffusion of environmentally friendly technologies.

Anti-Corruption
- Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.

Source: http://www.unglobalcompact.org/AbouttheGC/TheTENPrinciples/index.html (Accessed on 18 August, 2010).

A parallel discourse is that of business and human rights, a key framework for which has recently been developed by John Ruggie, the United Nations Special Representative to the Secretary General, which establishes the three-fold duty of "protect, respect and remedy".[5]

A key question in examining the legal framework for CSR is whether compliance with laws is part of CSR, or whether CSR starts where the law leaves off. Although traditionally CSR has been defined as "beyond law", in a country like India with a poor record of enforcement of environmental and labour laws, there is value in including legal responsibilities as the lowest rung within the framework of a corporate's responsibilities (Gautam, 2010).[6] In other words, compliance with the law is a necessary minimum, although it should not be the entire extent of a corporate's responsibility.

While the CSR discussions in the West have largely focused on businesses reducing their negative impacts (or improving their positive effects) on people and the planet, the Indian CSR discussion emphasises another element—philanthropy. Arguing that philanthropy has been a part of business, especially the ubiquitous family businesses in India through the ages, Sundar (2000; cited in Sood & Arora, 2006) traces the history of corporate philanthropy from the second half of the nineteenth century. The emphasis on philanthropy is also reflected in the practice of Indian corporates and their sponsored foundations,[7] especially in areas like health, education, and poverty alleviation, to such an extent that the term CSR is often used synonymously with philanthropic or community development initiatives.

The significance of corporate philanthropy, in addition to environmental, social and ethical responsibility, has also been highlighted in Indian CSR instruments, ranging from the Indian Prime Minister Manmohan Singh's Ten-point Social Charter for corporates,[8] to the voluntary codes developed by the Confederation of Indian Industry (CII) and the Federation of Indian Chambers of Commerce, as well as the Voluntary CSR Guidelines issued by the Ministry of Corporate Affairs (MCA) (highlights of the Voluntary CSR Guidelines are provided in Box 2).

In this paper, the term corporate social responsibility (CSR) is used to connote the responsibility of a corporate—including but extending beyond its legal responsibility—towards the environment and society, determined through its engagement with its stakeholders, and which encompasses the minimising of its adverse impact on stakeholders, as well as its contribution to their sustainable development through philanthropic initiatives.

Box 2: Framework of the Voluntary CSR Guidelines, Ministry of Corporate Affairs, India

Fundamental Principle
Each business entity should formulate a CSR policy to guide its strategic planning and provide a roadmap for its CSR initiatives, which should be an integral part of overall business policy and aligned with its business goals. The policy should be framed with the participation of various level executives and should be approved by the Board.

Core Elements:
The CSR Policy should normally cover [the] following core elements:

1. Care for all Stakeholders
2. Ethical functioning
3. Respect for Workers' Rights and Welfare
4. Respect for Human Rights
5. Respect for Environment
6. Activities for Social and Inclusive Development

Implementation Guidance:
In addition, the MCA Voluntary CSR Guidelines provide implementation guidance, including allocation of a specific amount in the budget for CSR activities and structured dissemination information on their CSR.

Source: http://www.mca.gov.in/Ministry/latestnews/CSR_Voluntary_Guidelines_24dec2009.pdf (Accessed on 18 August, 2010).

Should a corporate owe a responsibility beyond legal compliance?

There are of course those who argue that a corporate should not owe a responsibility beyond legal compliance. Many point to the Friedmanite assertion that the only social responsibility of business is making money.[9] However the proponents and practitioners of CSR give several reasons why a corporate should think beyond its legal obligations. These drivers range from ethical considerations among business leaders, to long-term sustainability of the corporate, which is a major concern for certain investors.[10] Value to the corporate itself (i.e. business case for CSR) is one

of the more popular drivers in terms of reduced risks or costs, or improved performance.

Several case studies have attempted to identify the environmental, social, or governance factors that lead to improved financial or operational performance, as for instance, in the matrix in Table 1 (SustainAbility and International Finance Corporation, 2002, available at www.sustainability.com).

Table 1: Business case matrix

The business case matrix		**Sustainability factors**						
		Governance & engagement		Environmental focus		Socio-economic development		
		Governance & management	Stakeholder engagement	Environmental process improvement	Environmental products and services	Local economic growth	Community development	Human resource management
Business success factors	Revenue growth & market access							
	Cost savings & productivity							
	Access to capital							
	Risk management & license to operate							
	Human capital							
	Brand value & reputation							

Source: SustainAbility and International Finance Corporation (2002).

From the more obvious factors like "brand value and reputation" to the more esoteric factors like "social license to operate" (i.e. acceptance from the community within which the corporate operates), corporates across sectors, geographies, and levels of maturity see different reasons that make the business case for CSR (Association for Stimulating Know

How, 2010; Global Reporting Initiative, 2009; SustainAbility and International Finance Corporation, 2002; SustainAbility and UNEP, 2001; among others).

Once CSR is defined and it is accepted that corporates can and should have a responsibility that goes beyond merely compliance with laws, the next question is how a corporate should go about addressing these responsibilities.

Appropriate framework to address CSR responsibilities

Being a cross-cutting issue, different aspects of CSR fall under different functions within a company, and this becomes problematic when addressing the CSR responsibilities of the company as a whole. Environmental matters are looked into by a different department from the one that looks into anti-corruption, while yet another one looks into project-related displacement of communities—there is generally no single body or structure tasked with examining the impact of corporate policies across stakeholders. Therefore it is suggested that the only way to address a cross-cutting issue like CSR is to bring CSR within a cross-cutting (or rather, overarching) regime that is well-established within corporates—the corporate governance framework.

Within the corporate governance framework, there are several corporate governance institutions and structures into which social and environmental concerns can usefully be integrated.[11] Two such institutions that have the potential to impact all other aspects of corporate governance are the responsibilities of the board of directors, which cover oversight of all corporate functions; and the reporting and disclosure regime, which again is geared towards collecting and processing financial and select non-financial information from different functions within the organisation.

Having defined CSR to not only include but also go beyond compliance with the law, both of these areas of contiguity are discussed below in terms of what Indian law currently provides for, and suggestions are made for how CSR can be effectively integrated into the corporate governance framework (drawing on the experience of other countries as well as examples from other fields of law within India).

3. Responsibilities of the board of directors towards stakeholders

Although there is a rich body of case law in India on the duties of individual directors (mostly negative duties against insider trading, making personal profit off a corporate opportunity, etc.), the legal framework does not clearly lay down the role of the board as a whole.[12] Even less guidance exists on the role of the board as regards stakeholders other than shareholders, although the Kumar Mangalam Birla Committee sought to achieve this by balancing the claims of stakeholders and shareholders. The Kumar Mangalam Birla Committee Report (1999) identified the fundamental objective of corporate governance as the “enhancement of shareholder value, keeping in view the interests of other stakeholders,” seeking to harmonise “the need to enhance shareholders’ wealth whilst not in any way being detrimental to the interests of the other stakeholders in the company” (para 4.2). However such a systemic approach regarding the board’s obligations towards the stakeholders has not yet found its way into the corporate governance legal framework.

In other words even the limited duties towards stakeholders that are imposed under corporate law are implemented in a scattered way. Very few corporates have a cohesive approach to identify and engage with their stakeholders.

Board responsibilities to stakeholders: Current state of Indian law

The legal framework for corporate governance in India consists by and large of the Companies Act, 1956 which applies to all companies (and is expected to be replaced in 2010 with a new Companies Bill), and Clause 49 of the Equity Listing Agreement that binds listed companies. Under the law relating to corporate governance, the Board is required to consider the interests of various stakeholders in specific contexts (some of which have been collated in Box 3). In addition the provisions of several environmental and social legislations also come into play, especially as relates to directors’ responsibilities and liability.

Box 3: Current state of Indian corporate law on responsibilities of the board to stakeholders

Stakeholder	Legal duty of the board to consider the interests of such stakeholder
Employees	Right to be heard in case of significant proceedings involving the company such as schemes of arrangement or winding up of the company. Responding to a workers' petition to be heard in the winding up of a company, the Supreme Court of India has held that "the company is a species of social organization, with a life and dynamics of its own and exercising a significant power in contemporary society. The new concept of corporate responsibility transcending the limited traditional views about the relationship between management and shareholders and embracing within its scope much wider groups affected by the trading activities and other connected operations of companies, emerged as an important feature of contemporary thought on the role of the corporation in modern society".[40] Information to be placed before the board under the Listing Agreement specifically includes matters impacting labour, such as fatal or serious accidents, dangerous occurrences, and significant labour problems and their proposed solutions, significant developments on Human Resources/Industrial Relations front like signing a wage agreement, implementation of Voluntary Retirement Scheme, etc.[41]
Environment	Although approached from an energy savings point of view, Section 217(1)(e) of the Companies Act requires the board report to discuss energy conservation measures of the company in the previous year (see Box 4 for details). Material effluent or pollution problems are required to be placed before the board under Annexure IA to Clause 49 of the Listing Agreement.
Consumers	Annexure IA to Clause 49 of the Listing Agreement also requires the board to be informed about any issue which involves possible public or product liability claims of a substantial nature, including any judgement or order which may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company.
Society	The catch-all agenda item of "non-compliance with any regulatory, statutory or listing requirements" under Annexure 1A would bring within the ambit of the board's discussion any non-compliance with the several labour welfare and environment legislations, as well as legislations prescribing a standard of conduct towards sections of society.

Source: Compiled by author, primarily from the Companies Act (1956), and the Listing Agreement.

Additionally businesses are required to comply with several environmental and social legislation,[13] many of which contain an "Offence by Companies" provision which imposes liability on the company as well as "persons in charge of and responsible to the company" for the conduct of its business (subject to due diligence defences). In addition such provisions provide that where an offence is committed with the "consent or connivance of," or "is attributable to any neglect on the part of" any director, manager, or any other officer of the company, such a person is also deemed to be guilty of that offence. In other words, a director can be liable under such a provision under the environmental and labour laws if he/she is "in charge of" and is "responsible to" the company for the conduct of its business, which in most cases will include the managing director; or the offence is committed with the "consent or connivance" of the director or is attributable to his/her neglect.[14]

The managing director and members of the board have been held to be prosecutable under a similar provision of the Water (Prevention and Control of Pollution) Act, 1974.[15] Similarly, in the case of wage and social security statutes, several cases have laid down that directors can be liable under the first prong of the above test.[16]

Liability for non-compliance inevitably leads to the conclusion that directors are obliged to and should also as a matter of prudence inform themselves of and actively monitor the company's compliance with laws that impact two of a company's key stakeholders—labour and the environment. The existence of such liability provisions should therefore be seen as identifying the non-shareholder stakeholders that legislators consider to be a part of the board's constituency.

Corporate philanthropy and the board's responsibility

We have (in light of the practice in India) included corporate philanthropy within the definition of CSR in this paper. As was stated earlier, CSR surveys of Indian corporates reveal the significance of philanthropy, especially in the areas of health, education, and poverty alleviation in the surrounding communities. Current corporate law can also be interpreted

as allowing a board to engage in corporate philanthropy as long as it is strategic philanthropy (i.e. it creates a business case). Section 293(1)(e) of the Companies Act allows the board to contribute up to Rs. 50,000 or 5% of the average net profits in the previous three years to *"charitable* and other funds *not directly relating to the business of the company or the welfare of its employees"* (emphasis added) without obtaining shareholder approval.[17] The emphasised text has been drawn upon by one of the leading authorities on Indian corporate law (Justice Chandrachud, 2006) to argue that the board has the power to donate the company's property beyond such limits, if some benefit accrues thereby to the company, i.e. if it is strategic philanthropy (p. 2923).[18]

However a revision of this provision has been sought in Clause 160(1)(e) of the Companies Bill, 2009 to entail the requirement of a special resolution of shareholders for the board to "contribute to charitable and other funds as donation in any financial year, an amount in excess of 5% of its average net profits for the three immediately preceding financial years". The revised provision may need to be further clarified since it can be interpreted in two ways as it stands now: (a) as allowing the board (upon receiving shareholder approval) to contribute up to 5% of the average net profits to *non-strategic* or cheque-book philanthropy; or (b) as allowing the board to contribute *any* amount (without limit) to strategic philanthropy that also meets a business case, requiring shareholder approval only for non-strategic charity.

Where the current law falls short and suggestions for the way forward

In the area of the board's responsibilities towards stakeholders, although the responsibilities of the board to specific stakeholders in *specific* situations are defined (see Box 3 for details), these are scattered over different legislations, the compliance of which is monitored by different departments of the company, and are not holistically viewed through the CSR lens. There is no comprehensive guidance to the Board as to stakeholders *generally*, such as for example under the UK Companies Act which requires company directors to consider several identified

stakeholders in their actions, including employees, suppliers, customers, the community, and the environment.[19]

This can potentially be addressed at a policy level by the proposed introduction in the Companies Bill (2009) of a specific board committee to consider and resolve the grievances of stakeholders. If passed in its current form, the Companies Bill will require this Stakeholders Relationship Committee to be constituted by all companies with more than 1,000 share-, debenture-, and other security-holders, and to be chaired by a non-executive director.[20] If broadened beyond merely stakeholder grievances, this legislative change can be utilised by corporates as an opportunity to develop a comprehensive strategy to identify stakeholders, engage with them, minimise negative effects on stakeholders in their immediate vicinity and direct corporate philanthropy strategically in a way that benefits key stakeholders.[21]

A reworded Clause 160(1)(e) of the Companies Bill, clarifying the limits (if any) on strategic and non-strategic corporate philanthropy should also fall within the mandate of this Stakeholder Relationship Committee in order to allocate discretionary CSR spending (or philanthropy) among stakeholders in a strategic manner.

4. Disclosure and reporting

The regime relating to disclosure and reporting is one of the cornerstones of corporate governance; the key corporate governance institutions—auditors, audit committee, annual general meeting, etc.—can be seen as various stages of the process of collecting, verifying (auditing), and presenting annual financial information to shareholders in the form of the Annual Report.[22] Although largely limited to financial reporting, some non-financial or CSR data is being reported by corporate India.

The term *CSR reporting* is used here to include reporting on non-financial or environmental, social and governance (ESG) risks and opportunities of the company (also known as ESG reporting or non-financial reporting), as well as reporting on its philanthropic activities.

In India, the term CSR reporting is often limited to the latter, but it clearly needs to embrace the former as well.

CSR reporting fulfils two policy purposes—increased transparency and therefore more effective engagement with stakeholders on CSR issues; and the highlighting of certain environmental and social concerns to the board and management (through the process of collecting material information, and creation of the report by the board and management).

The logic behind reporting to investors on environmental and social risks is unimpeachable. As was shown in the earlier discussion on the business case, there are several ways in which a corporate's social and environmental behaviour can affect its bottom line. In gaining a holistic perspective about a company, why would investors not want to know about potential material environmental and social risks and opportunities that can affect their investment as much as legal and regulatory risks?[23]

Despite the clear value to investors, most countries in the world show a poor record in terms of requiring a *holistic* integration of non-financial items of disclosure into Annual Reports, although *select* non-financial data (especially those which carry a large regulatory price-tag for non-compliance) are often required to be disclosed; e.g. environmental proceedings in the US Form 10-K Annual Report.[24] Similarly Indian law also requires select non-financial criteria to be reported, but as with board responsibilities to stakeholders, this is limited and scattered, having been introduced at different times based on what the current priorities were at that point in time.

CSR reporting: Current state of Indian law

Indian law requires a discussion of select ESG matters in the Annual Report (the significant provisions have been collated in Box 4). There is no such requirement as to disclosure of philanthropic initiatives, although the MCA's Voluntary CSR Guidelines recommend a broader dissemination of "information on CSR policy, activities and progress in a structured manner to all their stakeholders and the public at large through their website, annual reports, and other communication media" (p. 13).

The practice in this case goes far beyond the legal requirement. Several Indian companies voluntarily include ESG disclosure as well as information on their philanthropic programmes and initiatives within their Annual Reports, and some also produce annual Sustainability Reports.[25] However both these groups consist primarily of large corporates. The level or quality of ESG disclosure has also been questioned,[26] as has the general accessibility of this information,[27] unless disclosed on the corporate website. Where one of the aims of CSR reporting is to provide access to the corporate's CSR information to the stakeholders, and thereby improve the quality of stakeholder engagement, the lack of a centralised database where all company filings can be easily accessed by the public poses a serious issue.

Box 4: Current state of Indian law on ESG disclosure in the Annual Report

Subject	Indian law regarding ESG disclosure in the Annual Report
Environment	Section 217(1)(e) of the Companies Act requires the board to report on energy conservation measures by the company in the previous year. Under this Section, the Companies (Disclosure of Particulars in the Report of Board of Directors) Rules (1988) require the Board to report on: (a) the energy conservation measures taken; (b) additional investments and proposals, if any, being implemented for reduction of consumption of energy; (c) impact of the measures at (a) and (b) above for reduction of energy consumption and consequent impact on the cost of production of goods; and (d) total energy consumption and energy consumption per unit of production as per the provided form in respect of certain high energy consumption industries.
Labour	The MD&A report, which is part of the Annual Report, requires discussion of "material developments in Human Resources, Industrial Relations front, including the number of people employed." (Clause 49(IV)(F)(i)(viii) of the Listing Agreement) Quarterly financial results must disclose all events or transactions "material to an understanding of the results for the quarter" which include strikes and lock-outs. (Clause 41(IV)(k) of the Listing Agreement)
Corporate Governance	The Corporate Governance Report should discuss matters such as the company's philosophy on governance, as well as information on various aspects of board, audit committee, related party transactions and non-mandatory good practice matters such as whistle-blower policy and director training.

Source: Compiled by author from the Companies Act (1956), and the Listing Agreement.

The way forward: Two approaches to improved ESG disclosure

In this area it is clear that although small steps are being taken, a holistic overhaul is needed in order to mainstream ESG reporting.[28] This can be done in two ways—through voluntary sustainability reporting, or legislatively, by mandating disclosure of key ESG information within Annual Reports.

Voluntary sustainability reporting: The practice of sustainability reporting is gaining popularity across the world and also in India. Sustainability reporting involves "reporting on economic, environmental, and social impacts",[29] sometimes used synonymously with triple bottom line reporting, corporate responsibility reporting, and non-financial reporting. The most popular framework for sustainability reporting internationally is the Global Reporting Initiative's *G3 Reporting Guidelines*.[30]

Although sustainability reporting provides the most detailed framework for CSR reporting, it is necessarily outside the scope of the legal framework of financial reporting, and provides an alternate (voluntary) framework. Detractors of sustainability reporting also point to the fact that in practice corporates sometimes misuse sustainability reporting for marketing.[31] Since no liability under securities laws attaches to statements made in sustainability reports, unlike those made in Annual Reports,[32] disclosure controls tend to be weaker and such reports therefore sometimes carry statements that are less rigidly vetted than similar statements contained in the Annual Report. On the flip side, mandating significant levels of ESG reporting in the Annual Report is likely to impose burdens on smaller companies, at least in the short run. Therefore, voluntary sustainability reporting by corporates needs to go hand in hand with gradually increasing levels of mandatory reporting of select ESG data in the Annual Report.[33]

Integration of ESG into Annual Reports: Most legal systems (including India) require the disclosure of select ESG criteria in company Annual Reports (see Box 4).[34] Whereas the approaches of most countries are fragmented, some countries have overhauled the disclosure rules to

fully integrate ESG factors within the financial reporting framework. The second report of the South African committee on corporate governance, headed by Mervyn King (popularly called the King II report) recommends "integrated sustainability reporting," i.e. an integrated approach to financial and non-financial reporting, including local issues of concern such as HIV/AIDS, and procurement in line with the Black Economic Empowerment Act.

In one of the most comprehensive approaches to mandating non-financial reporting within the Annual Report, the law overhauling the French corporate law in 2001—the *Nouvelles Regulations Economique* (NRE)—introduced a requirement for French listed companies to produce a sustainable development report within their Annual Reports, containing detailed information on human resources, including compensation, health and safety information and gender-diversity data; community involvement, which includes local partnerships with NGOs and others within the community and disclosure of labour compliance by subcontractors; and environment, including resource use, emissions, biodiversity and environmental management.[35]

The sustainable development report is required to be shared with the company's Works Council as well as auditors, and is also to be presented to the board of directors. It therefore is an example of a law that mainstreams CSR concerns within the entire corporate governance structure through CSR reporting. Although initially the quality of reports produced under the NRE was considered poor, there has been a significant increase in focus on CSR within French corporates, which has been linked to the regulatory push factor of NRE.[36]

While the French NRE was the legislative driver to improved ESG reporting, other actors have played a role in this regard in other parts of the world. Self-regulatory organisations (such as stock exchanges) have the mandate as well as the legal flexibility to require companies listed on their exchanges or indices to report on ESG. A case in point is the Malaysian stock exchange (Bursa Malaysia) which began by publishing CSR guidance

for companies in September 2006 and gradually worked with Malaysian regulators to move to a mandatory CSR reporting regime. The Malaysian Listing Rules now require Annual Reports of listed companies to include a description of their CSR activities and practices (or to state that there are none).[37]

Regulatory guidance on specific ESG issues: An alternate approach is one that focuses the regulatory push on a specific ESG issue of concern to the country. This is an approach that was successfully followed in the 1988 amendment to the Indian Companies Act that introduced Section 217(1)(e), which requires the Board to annually submit a detailed report on energy conservation measures, including the impact of the measures and the total energy consumption and energy consumption per unit of production. In other words, Section 217(1)(e) requires the boards of certain manufacturing businesses to focus their attention on operational matters such as energy consumption, bringing this otherwise delegated subject to the attention of the highest decision-makers within the corporate.

A recent example on issue-specific disclosure is the interpretive guidance issued by the US Securities and Exchange Commission (SEC) on climate change disclosures. Interpretive guidance does not create legal requirements; it is instead intended to clarify existing requirements. However, issuers and their advisors look closely to such guidance, which therefore has the desired effect of bringing the issue before the corporate decision-makers. The SEC interpretive guidance identifies the existing heads of disclosure of Regulation S-K, under which climate change disclosure may be required if it is "material,"[38] and further identifies four areas—impact of legislation and regulation, international accords, indirect consequences of regulation or business trends, and physical impact of climate change—as examples of situations where climate change disclosure may be required.

The SEC interpretive guidance comes after several years of lobbying from CalPERS, CERES and other institutional investors and civil society groups.[39]

5. Conclusion: The normative picture and the way ahead

As was noted earlier, Indian law provisions on CSR are scattered across legislations in different areas and need to be collated under a single umbrella for corporates to be able to develop a systemic or institutional approach to CSR and their responsibilities to stakeholders. With some additional policy input and legislative changes, the existing corporate governance legal system can provide the enabling environment for improved ESG integration by corporates within their business.

Within the field of board responsibilities towards stakeholders, the scattered provisions on board responsibility towards certain stakeholders, as well as the liability of directors for a company's non-compliance with environmental and labour laws make it clear that Indian law intended for the board to be responsible, at least to certain stakeholders. However what is missing is legal or regulatory guidance regarding a comprehensive approach towards stakeholders, which includes philanthropic initiatives. This has the potential to be addressed under the proposed Stakeholder Relationship Committee under the Companies Bill, if its purpose can be broadened beyond merely addressing stakeholder grievances. Unlike the UK Companies Act (which identifies key stakeholders and requires the board to consider their interests) the proposed change under the Companies Bill leaves the identification of its stakeholders to the board/ committee of the concerned corporate. This provision should therefore be utilised by corporates to engage in a strategic stakeholder identification and engagement exercise. Clause 160(1)(e) of the proposed Companies Bill regarding corporate philanthropy also needs to be clarified and the discretionary CSR spending allowed under the Companies Act should also be utilised by boards in a strategic manner.

In the area of CSR reporting, although scattered ESG reporting is mandated under the disclosure regime, a more holistic approach is needed, with regard to corporate practice as well as at the policy level. Among corporates, the trend as to ESG reporting, within Annual Reports and as stand-alone sustainability reports, must spread beyond the large corporates. In view of the limitations of the filings databases maintained by SEBI and

the stock exchanges, all corporates should consider making their filings simultaneously available on their websites.

A broad-based policy discussion is also needed regarding the legislative, regulatory and other changes needed for a deeper integration of significant ESG issues into the disclosure regime, by identifying ESG issues that should be brought to the attention of the board, by requiring the board and management to disclose such information in the board report, as was done with energy consumption under Section 217(1)(e) of the Companies Act; ESG data that should be collected, audited and broadly disclosed to stakeholders through the Annual Report; and additional ESG data that is useful for stakeholders, but cumbersome for all corporates to collect and verify, which could be disclosed under a sustainability reporting framework that can be voluntarily adopted by corporates.

In the policy discussion, the examples of other countries can be referred to, although legal policy changes must be carefully considered in light of local conditions (Varottil, 2009).

A combination of drivers is required for improved corporate responsibility, and the law is only one of them. The value of legal change should not be overestimated—India is an example of how the best laws, if not effectively enforced, are powerless to change behaviour. But the power of law should also not be underestimated—as legal developments regarding non-financial reporting in other countries have shown, legal and regulatory changes can highlight issues and create awareness, and thereby catalyse a movement towards corporate responsibility.

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Notes

[1] The term corporate has been used intentionally so as not to limit the discussion to entities of a specific legal form, such as companies, but at the same time to clarify that small unorganised businesses are not the focus of this paper (as they face very different governance issues). However where the Companies Act or Listing Agreement provisions are referred to, the use of the term company is appropriate in view of the fact that these laws apply only to companies.

[2] For details, see "PSE Dept may come under corporate affairs ministry", The Economic Times, 25 January 2010.

[3] The term CSR is also sometimes used interchangeably with corporate citizenship, enterprise or business responsibility, and even corporate sustainability.

[4] The current draft of the ISO 26000, and related documents and comments are available at http://isotc.iso.org/livelink/livelink?func=ll&objId=3934883&objAction=browse&sort=name (Accessed on 26 January, 2010). The ISO 26000 identifies the following principles of social responsibility—transparency, accountability, ethical behaviour, respect for stakeholder interests, respect for rule of law, respect for international norms of behaviour, and respect for human rights. It also gives guidance to organisations for the integration of social responsibility within the organisation.

[5] The Ruggie framework (2008) is available at http://www.reports-and-materials.org/Ruggie-report-7-Apr-2008.pdf (Accessed on 26 January, 2010). The framework comprises three core principles—the State duty to protect against human rights abuses by third parties, including business; the corporate responsibility to respect human rights; and the need for more effective access to remedies (by the State—judicial and non-judicial—as well as by company-level remedies).

[6] Gautam (2010) makes a case for the inclusion of legal compliance within the definition of CSR. There is some academic support for this contention, like Carroll's CSR pyramid (Carroll, 1991) which includes legal responsibilities as one of the levels of corporate responsibility. Compliance with laws is also one of the principles underlying

the ISO 26000 Social Responsibility Standard, although its inclusion proved somewhat contentious in the ISO negotiations.

[7] A survey of 500 companies operating in India shows that about 70% support weaker sections of society through their community development initiatives (Partners in Change, 2007). These initiatives target (in descending order of popularity among the survey universe) people affected by natural disasters, children, women, youth, the girl child, physically challenged, elderly, people living with diseases, tribal, homeless, and dalit. Significant issues include health and education. In terms of manner of engagement, the survey noted (again, in descending order of popularity) employee volunteering, cash donations, donation of products and services, provision of company facilities, skills/ business training to NGO staff and preferential purchase of materials from community or NGO staff. Another significant regular CSR survey in India notes that 11% of the 1000 surveyed companies do CSR through their own foundation or trust and key areas for initiatives include education, healthcare and rural development (Karmayog, 2009, p. 9).

[8] The transcript of the speech is available at http://pmindia.nic.in/speech/content.asp?id=548 (Accessed on 21 January, 2010).

[9] For a succinct summary and assessment of Friedman's theory, see Melee (2008, pp. 55–62).

[10] One of the barriers to the integration of environmental, social and governance (ESG) concerns into mainstream investing is the short-term focus of many investors and the importance of earning targets over long-term economic value (Business for Social Responsibility, 2008).

[11] For instance the corporate governance field of "risk management" can benefit from the integration of CSR or environmental and social risks, which will give investors a more holistic picture. Similarly elements of CSR or environmental and social audit can be included within the financial audit function.

[12] For instance should the role of the board be strategic guidance, management, oversight, watchdog function, or a combination of the above? Although the law is silent on the subject, there has been some discussion on this in academic literature. Further the board charters of some companies specifically address this issue by setting forth the role of the board as well as of each committee. The Kumar Mangalam Birla Report (1999) identified the role of the board as: directing the company (i.e. formulating policies and plans), control of the company and management, and accountability to shareholders.

[13] For instance, Section 25 of the Contract Labour (Regulation and Abolition) Act, 1970, Section 11 of the Equal Remuneration Act, 1976, and Section 16 of the Environment (Protection) Act, 1986. Gautam (2010) surveys the legal obligations of a business that form the baseline for its corporate responsibility towards stakeholders in the following seven areas of the law—corporate governance, environment, labour, competition, consumer protection, resettlement and rehabilitation and corruption.

[14] See National Small Industries Corp. Ltd. vs. Harmeet Singh Paintal & Ors., Criminal Appeal No. 320-336 of 2010 (Supreme Court), interpreting a similarly worded provision in the criminal law context of directors' liability under Section 141 of the Negotiable Instruments Act, 1881 for bounced cheques.

[15] See U.P. Pollution Board v. Modi Distillery, 1987, 2 Comp LJ 298 (SC). However, the Chairman and Vice Chairman were held to not be responsible for the conduct of the company's business under a similar provision in the Air (Prevention and Control of Pollution) Act, 1981 in N. A. Palkhiwala v. M. P. Pradhushan Niwaran Mandal, Bhopal, 1990 Cr. LJ 1856 (MP).

[16] See Siddharth Kejriwal v. ESI Corp., (1997) 90 Com Cases 496 (Kar.), in the context of the Employee State Insurance Act; Rajagopalachari (S.) v. Bellary Spg. And Wvg. Co. Ltd., (1997) Com Cas 485 (Kar.) in the context of the Employee Provident Fund Act; and Hari Charan Singh Dugal v. State of Bihar, (1990) 3 Corp LA 234 (Pat), in the context of the Minimum Wages Act.

[17] Section 293(1)(e) of the Companies Act, 1956.

[18] The example cited in Justice Chandrachud (2006) is the donation of a parcel of land to build a road, by which the company itself or its employees are likely to receive some benefits such as improved efficiency or inducement to increased efforts on the part of employees.

[19] Under Section 172 of the UK Companies Act (2006), a director of a company must act in the way he/she considers (in good faith) would be most likely to promote the success of the company including to have regard to "(a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct".

[20] Clause 158(12) of the Companies Bill (2009).

[21] A model under the stakeholder theory developed to measure the salience of stakeholders and allocate discretionary CSR spending has been proposed in Dunfee (2008).

[22] Although detailed information is required to be disclosed to potential purchasers at an initial public offering, this disclosure to the primary markets is a one-time activity, and therefore closer to the field of investor protection than corporate governance. In this article therefore, we limit the discussion to periodic disclosure.

[23] Several ESG risks and opportunities have been identified that are key to investors and should therefore be disclosed, including "...major public issues...which are linked to key products (e.g., concern over obesity trends affecting companies that sell food products);...issues that will drive changes in company cost structure (e.g., compliance with new legislation, outsourcing and workforce restructuring), and issues that relate to reputation" (Global Reporting Initiative, 2009, p. 7). The recent British Petroleum oil spill off the Gulf of Mexico is a classic example of an environmental risk and potentially enormous environmental liability which resulted in the plummeting of the company's share price.

[24] Items 101(c)(xii) and 103 of Regulation S-K read with Item 1 (Business) of Form 10-K. See, especially, Instruction 5 to Item 103 of Regulation S-K read with Item 3 of Form 10-K which requires even routine environmental litigation to be disclosed subject to certain conditions. Other routine legal proceedings need not be disclosed.

[25] Around 56 Indian companies report on environmental and social factors; 35 of these produce sustainability reports using the reporting guidelines of the Global Reporting Initiative, according to UNEP, KPMG, GRI, Unit for Corporate Governance in Africa (2010).

[26] A study which ranked 10 emerging markets based on the reporting of identified ESG indicators in their annual reports by 10 economically significant companies in each of these countries, placed India in the eighth position, followed only by China and Israel (Social Investment Forum and Emerging Markets Disclosure Project, 2009). See also the studies cited in footnotes 75 and 76 in Varottil (2010).

[27] Unlike the EDGAR database in which all public filings of US public companies are maintained and accessible by the public, the two Indian databases—EDIFAR and Corpfilings—are difficult to access. Further, not all listed companies' information is maintained in these databases (Asian Corporate Governance Association, 2010, pp. 39–40).

[28] Since ESG reporting holds the key to reducing a corporate's environmental and social footprint, is the focus of the following section will be ESG reporting rather than reporting on the corporate's philanthropic initiatives.

[29] Global Reporting Initiative Reporting Guidelines (p. 3), Accessed on 23 January, 2010 (www.globalreporting.org).

[30] Available at http://www.globalreporting.org/ReportingFramework ReportingFramework Downloads (Accessed on 23 January, 2010). A 2008 study by KPMG found that of the Global Fortune 250 companies, nearly 80% issued corporate responsibility reports, and another 4% integrated some aspects of corporate responsibility into their annual reports. Of the G250 companies, 77% used the GRI G3 Reporting Guidelines to do so (KPMG, 2008).

[31] A 2007 KPMG and GRI study on climate change found that "companies reported far more on potential opportunities than financial risks for their companies from climate change" (KPMG-GRI, 2007).

[32] Rule 10b-5 of the Securities Exchange Rules under US law and regulatory guidance under this rule provide a detailed frame of liability for false and misleading statements made to the public. Under common law, Hedley Byrne & Co. Ltd. v. Heller and Partners Ltd., (1963) All ER 575 (House of Lords) establishes the liability of directors towards shareholders who rely on a misstatement.

[33] A model for understanding the complementarity of mandatory and voluntary reporting is proposed in Box 1 (p. 8) of UNEP, KPMG, GRI, Unit for Corporate Governance in Africa (2010).

[34] For an overview of ESG disclosure under the securities laws of other countries, see Lin (2009), pp.3–4 regarding developed countries, and pp. 15–25 regarding securities ESG disclosure in five emerging markets (South Africa, Malaysia, China, Taiwan, and Thailand).

[35] Article 116, paragraph 4 of the NRE. For an English summary, see Table 1 in Egan et al., (2003, pp. 11–12).

[36] See Global Public Policy Institute (2006, p. 27).

[37] For details, see Bursa Malaysia (Case Study) on "WFE – World Federation of Exchanges". Accessed on 13 March, 2010 (http://www.world-exchanges.org/sustainability/m-6-4-1.php).

[38] Under the SEC Release, climate change disclosure may be required in the Annual Report on Form 10-K under the headings Business, Legal Proceedings, Risk Factors, and MD&A of Regulation S-K.

[39] For a list of the several petitions submitted to the SEC for interpretive guidance on climate change, see footnote 20 in Securities and Exchange Commission (2010, p. 7).

[40] For details, see National Textile Workers' Union v. P. R. Ramakrishnan, A.I.R. 1983 SC 75. The Companies Act also provides for overriding preferential payment for workmen's dues in case of winding up under Section 529A of the Companies Act, which is currently slated to continue in the same form in the Companies Bill, 2009 as Clause 301 of the current draft.

[41] Annexure IA to Clause 49 of the Listing Agreement.

[42] See Annexure 1C to Clause 49 of the Listing Agreement for details regarding the mandatory items of disclosure, and Annexure 1D for details on the optional disclosure items of corporate governance.

13

The Role of Reputation Agents in Corporate Governance

Sammy Medora, Ganesh Ramamurthy

1. Introduction

In the context of corporate governance, reputation agents are those who provide assurance or endorse corporate communications based on which outsiders make decisions. Since the public relies on their statements of assurance, it is important that reputation agents maintain and enhance their own reputations with impeccable conduct at all times. In performing their duties, reputation agents should maintain high standards of personal and professional integrity, be objective in the advice they offer, and in certain circumstances (for instance, in the case of external auditors) ensure they are independent in substance and form. These reputation agents have a principal-agent relationship with those who appoint them—the relationship between shareholders and statutory auditors is a classic example. Reputation agents also have an indirect responsibility to stakeholders (for instance, regulators, employees and the media) who rely on the assurances they provide.[1]

2. Key approaches to corporate governance

The principal-agent model of corporate governance

In the classical principal-agent theory (otherwise known as agency theory), the relationship between owners (principals) and company managements (agents) is characterised by the delegation of the decision-

making authority to agents (Jensen & Meckling, 1976). The agent plays an instrumental role in studying the various dimensions of a business, like suppliers, costs, employees, customers, and/or investors. The agent is required to conduct his/her efforts in the best interests of the principal. However, as both parties are committed to maximising their own utilities, this model recognises the agency costs that materialise from the separation of ownership and control. Agents are likely to have motives that differ from those of their principals. There is thus a predisposition for certain conflicts of interest between the management, shareholders, and/or debt-holders. These mismatches of interest can arise from asymmetries in the distribution of earnings and/or information asymmetries. These asymmetries could lead to an eventuality where firms could take more risk than their appetites would otherwise allow.

Since it is not practically feasible for the principal to monitor the activities of agents at all times, there is a risk of opportunistic self-serving behaviour on the part of the agents. Principals can lack trust in their agents in view of these information asymmetries too. In this context, auditors serve as reputation agents as they are integral to validating the trust that principals place on their agents. It is within this framework that the agency theory helps to explain the development of audit by depicting agency relationships between principals and directors/managers. In this sense, auditors are crucial in their role as reputation agents as they provide an independent check on the work of agents and help to preempt or reduce the probability of conflicts that arise from divergent interests of principals and their agents, or report on such conflicts that may survive so that the principals are duly informed.

The associated issue is the validation of the auditing intermediary itself. How can investors trust the auditor to diligently discharge its duties and truthfully report back to the principals? This is where the auditor—acting as an appointed agent for this purpose—stakes its own reputation (and hence qualifies as an important reputation agent) for objectivity, integrity, and competence to do the tasks assigned to it. These are ensured by its professional training and education, experience, regulatory

discipline, and track record, as well as the skill sets and tools it employs in carrying out its assigned job without fear or favour, and the reputation associated with the professional institutes and their own processes, first to impart the necessary education and training to build necessary capacity, and thereafter to monitor and ensure that their members acquit themselves creditably on pain of disciplinary actions.

In light of a flurry of corporate scandals at the start of the twenty first century, there have been ongoing demands for an improvement in audit quality globally. In 2003, the Council of International Federation of Accountants (IFAC) reviewed its governance activities and regulatory responsibilities, unanimously approving a set of reforms that were introduced to improve global audit quality. The objectives of these reforms were to strengthen the standard-setting processes of international audit, and to ensure that the international accountancy profession would also be sensitive to public interest. Claimed to be the most comprehensive in the history of IFAC's initiatives, these reforms have been amply supported by international regulators. To this end, a Public Interest Oversight Board (PIOB) was established to oversee IFAC's compliance and standard-setting activities with respect to audit, assurance, ethics, and independence. Likewise, the efforts to infuse greater transparency in audit and in the accountability of auditors in the UK are as a welcome change in this regard. In the UK (which follows a simple agency audit model),[2] auditors are directly accountable to and owe a duty to a company's existing shareholders as a body. The Audit Quality Forum has also been proactive in undertaking measures to strengthen shareholder involvement in the audit process.

In India, the Financial Reporting Review Board (FRRB) was constituted by the Institute of Chartered Accountants of India (ICAI) to review compliance with auditing and accounting standards, and to improve the overall quality of audit services. Even though the Quality Review Board (QRB) was set up additionally as an accounting oversight body in 2007, significant efforts to improve audit quality in India are few and far between as the QRB is neither completely independent nor fully operational—a concern elaborated upon later in this paper.

The orthodox and neoclassical framework of the principal-agent model is inadequate in explaining the successes and failures of the governance structures of certain types of businesses, such as family-owned businesses and/or owner-managed corporate entities, both of which are predominant in India and most Asian and European countries.

The stakeholder approach to corporate governance

While the value of the principal-agent model cannot be discounted, it has been challenged by a number of scholars and practitioners, and charged with defining the corporate purpose too narrowly as being shareholder wealth maximisation. A broader view would take into account the interests of a wider range of stakeholders (Freeman, 1984). The key stakeholders would vary from firm to firm in terms of their contribution and importance but generally a firm's customers, vendors, financiers (including shareholders), employees and managers, the government, and the community are included as stakeholders. Given the varying levels of development and social awareness, different countries and regions (and indeed different industries and business segments) assume predominant claims on the corporation. Customers and employees have received substantial attention, as have environmental and societal issues in recent years.

In the stakeholder approach to corporate governance, a business entity (with its nexus of relations) must conduct its activities in a way that balances a variety of often non-congruent stakeholder interests. Companies increasingly view reputation agents as strategic partners as there is a perceptible link between corporate reputation and the reputation agents whom companies engage. Audited financials and audit opinions are the basis for vendor and customer relationships as well as employee negotiations and government assessments for tax and other purposes. Potential financial collaborators and funding agencies rely on the firm's audited financials and credit rating agencies' ratings as the bases for the assessment of their due diligence and creditworthiness respectively. The stock exchanges where a company's securities are listed and the standards of regulatory design and enforcement discipline are useful

indicators for investors. The standing and reputation of these reputational agents therefore are a valuable and necessary input for a wide variety of a firm's stakeholder community. It follows that stakeholders often perceive companies in a positive light if they are rated by reputed agencies, engage well-known auditors, are listed on respected stock exchanges, report sound control and risk management assurances, and are favourably portrayed by the country's media.

3. Reputation agents in corporate governance

We now turn to a detailed consideration of select reputation agents and the nature, status, and potential of their role in upgrading the standards of corporate governance in the country.

Independent auditors

High-quality performance by independent accounting professionals benefits the economy and society by contributing towards the efficient allocation of financial resources and towards enhancing the efficiency of financial and capital markets (and through these, to the efficiency of production of goods and services). Independent auditors, with their certifications, help achieve a more informed and objective appreciation of the governance risks that investors and other stakeholders face with regard to specific corporate units.

Accounting and reporting are essential prerequisites of a strong financial infrastructure and a trusting investment climate, both of which are vital ingredients of success in economic growth and the expansion of business, trade, and investments. One of the core responsibilities of independent auditors is to provide assurance to shareholders and stakeholders regarding the true and fair nature of the information presented in their audit clients' financial and other related statements. The importance of the audits of companies is uncontested. Capital markets could not function unless investors have some reasonable idea of the performance and financial position of the companies whose securities they buy and sell. Independent auditors serve as reputation agents because the public relies

heavily on their audit opinions to make investment decisions. The public perceives accounting firms to be independent and objective entities, free from the influence of their audit clients and other third parties.

High-quality financial reporting is critical to investor confidence. Financial reporting and corporate governance must both be supported by transparent and effective systems of monitoring and prudential enforcement. This is consistent with the principles of adopting international standards, regulatory coordination, transparency, and supporting open markets and investment that were agreed to at the G20 London Summit (2009).

The current scenario with respect to independent auditors is detailed below.

Audit of financial statements

Companies prepare and issue financial statements that reflect their performance over a (recent) period (typically a quarter or a year) and conform to a set of accounting principles that are generally accepted. The responsibility of preparing a company's financial statements lies with the management. The role of an auditor is to express an opinion on those financial statements, and to plan and perform the audit to obtain reasonable assurance that these financial statements are free from material misstatement.

Chartered Accountants (CAs) in India function under the regulatory provisions and the Code of Ethics laid down by the Institute of Chartered Accountants of India (ICAI), founded by the Chartered Accountants Act (1949) to develop and regulate the profession of chartered accountants. The ICAI first undertook the task of setting the standards of accounting in India in 1977. However, the accounting standards issued by the ICAI were mandatory only for its members. The Companies (Amendment) Act (1999) mandated compliance with accounting standards in the preparation of accounts. The government prescribes these standards issued by ICAI in consultation with and as recommended by a National Advisory Committee on Accounting Standards (NACAS).

Promoting globally consistent standards for reporting and auditing

(1) Convergence with International Financial Reporting Standards (IFRS): Indian GAAP (generally accepted accounting principles) has evolved significantly over the last two decades leading to substantial improvements in financial reporting. While Indian standards are being modeled primarily on the basis of the IFRS , there are differences broadly in the areas of business combinations, consolidation, financial instruments, comparatives and presentation, to mention a few. Based on the recommendations of its study group, the ICAI has proposed full convergence with IFRS with effect from the accounting period commencing on or after 1 April 2011.

(2) Harmonisation with International Standards on Auditing: Indian auditing standards are largely based on the corresponding International Standards of Auditing (ISAs), with certain differences in the areas of quality control, analytical auditing, joint audits, reliance by a principal auditor on the work of the other auditor, etc. Auditing standards in India are formulated by the ICAI through its Auditing and Assurance Standards Board which has now embarked upon a programme of convergence with ISAs. This task presents several challenges, such as ensuring that relatively smaller firms also robustly fall in line.

The ICAI has issued a Standard on Quality Control (SQC) to offer guidance regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information and for other assurance and related engagements. The scope of professional misconduct in the ICAI's Code of Ethics covers the following areas— failure to exercise due diligence;[3] certifying and/or submitting reports without examining related records; failure to disclose any material fact(s) in a financial statement; failure to report a known material misstatement in a financial statement; failure to obtain sufficient information to express an opinion; failure to invite attention to any material departure from Indian GAAP; and bringing disrepute to the ICAI (even if the action does not relate to the profession).

Written representations

Written management representations are used to corroborate the validity of the premises that relate to management's responsibilities and other forms of audit evidence obtained with regard to specific assertions in the financial statements. Such written representations provide necessary audit evidence of the validity of these premises. They are hence necessary to corroborate other forms audit evidence, particularly those where judgement, intent and/or completeness are involved.

Independence

IFAC has adopted a set of principles-based criteria to establish independence. In India, the ICAI's Code of Ethics revolves around a set of professional ethical standards that regulate the relationship between CAs and their clients, employers, employees, fellow members of the ICAI, and the general public In addition to these standards, other regulators like the Reserve Bank of India (RBI) prescribe their own restrictions. The Companies Bill of 2009 introduces new independence measures and explicitly states that statutory auditors of companies must not render certain types of non-audit services due to potential conflicts of interest. Given the importance of independence to the audit process, multiple independence standards result in an overlap of enforcement regimes. Although there is a need for the effective enforcement of these standards, the universal adoption of a set of independence standards (perhaps those of the IFAC) would prevent complications associated with multiple definitions of independence.

Fraud detection

There is a significant "expectation gap" between what stakeholders believe auditors do in order to detect fraud and what audit networks are actually capable of doing. Prevailing auditing standards require auditors to conduct audits with a healthy degree of scepticism, always recognising the possibility that fraud could occur. The standards offer guidance on what auditors can do to uncover frauds that do exist. Given the inherent limitations in external audits, there is a limit to what auditors can reasonably

uncover. Given the time and resources constraints as well as the relatively low levels of audit fees, auditors tend to use indirect means to ascertain whether frauds have occurred, such as examinations of accounts and records with the main aim of looking out for anomalies, interactions with company employees and managements that are not under oath, as well as reviews of a company's internal controls.

While these methods are clearly useful and essential in reasonably preventing and discovering frauds, they are not and cannot be foolproof. Hence the expectation gap arises because many investors, policymakers and the media erroneously believe that the auditors' main function is to detect fraud, and are often erroneously presumed to be at fault if they failed to spot one that is discovered later.

Rotation

Only a handful of countries (notably the USA, Indonesia, India, Italy, Poland, Saudi Arabia, and Singapore) currently require some form of audit firm rotation after a predefined period. Of all the G20 economies, only Italy has mandatory firm rotation on a continuing basis. The IFAC's Code of Ethics mandates the rotation of the lead audit partner once every seven years to safeguard the firm against over-familiarity. The ICAI's SQC requires audit partner rotation for listed companies not later than a pre-defined period of seven years. The voluntary corporate governance guidelines recently provided by the Ministry of Corporate Affairs (MCA) suggest rotating the audit partner once in three years and the audit firm once in five years, to maintain the independence of auditors.[4]

Joint audits

France has a tradition of joint auditors (of all the G20 nations). While Denmark had a system of mandatory joint audits earlier, it was abandoned in 2005. There are significant disadvantages associated with conducting joint audits. These involve increased costs to companies, a reduction of competition for non-audit services, blurred responsibilities, a decline in quality, and the danger of unlevelled field vis-à-vis international counterparts.

Next, we consider some key improvement levers for improving audit quality.

Quality control

ICAI has issued the Standard on Quality Control (SQC)-1 which applies to audits and other assurance related services engagements.[5] The purpose of the SQC is to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements. It requires the firm to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partner are appropriate in the circumstances.

The firm's system of quality control includes policies and procedures addressing leadership responsibilities for quality within the firm; ethical requirements; acceptance and continuance of client relationships and specific engagements; human resources; engagement performance; and monitoring.

The audit firm should share the quality control document with at least the listed company clients at the time of appointment, and it should be updated periodically to reflect the changes in the policies and procedures of the firm. This would assist in achieving transparency about the operations of the firm with the significant stakeholders.

Written representations

Written representations do not by themselves constitute sufficient/ appropriate audit evidence of the validity of these premises. Furthermore, independent auditors are not relieved of their responsibilities to obtain other forms of audit evidence related to management representations. A strong peer review mechanism is desirable to help auditors comply with their responsibilities.

The audit committee should institute the practice of reviewing the company's letter of representation to assess whether the representations

obtained are reasonable and valid in the context of the audit procedures performed and whether there are any areas where the auditors have unduly or excessively relied on management representations.

The other areas that require improvement include fraud detection, regular forensic audit, freedom of choice in auditor selection, rotation, etc.

What is sorely needed is a constructive dialogue between investors, stakeholders, policymakers and auditors, on the efforts that should be initiated to bridge the 'expectation gap' relating to fraud. However, this dialogue must recognise that the auditing profession is committed to continuously improving its abilities and methods to detect fraud. This is being done through the commitment of resources to support research into new methodologies and technologies that will expand the ability of an auditor to detect fraud.

The most aggressive (and also costly and intrusive) way of rooting out fraud involves mandating all public companies to undergo a forensic audit at least once every two to three years. Unlike the indirect means used to detect frauds in a conventional audit, a forensic audit resembles a police investigation. Forensic auditors scrutinise all records of the company (including emails), and question employees under oath. It might be necessary for an audit network or a specialised forensic auditor to perform a forensic audit with the aid of independent lawyers who have not represented the audit client during the period under review.

A less expensive version of the forensic audit idea would be to subject a sample of Indian listed companies to a forensic audit on a random basis. Although such a system might uncover fewer frauds, the deterrent effect could still be powerful because listed companies would know that they could be subject to forensic scrutiny at any time.

Regardless of whether our policymakers choose to mandate forensic audits on any basis, it is possible to close the 'expectation gap' by introducing more choices with regard to the intensity of audits. Since forensic audits are conducted primarily for the benefit of investors, one possibility would

be to let shareholders decide the intensity of the fraud detection effort they would like their auditors to perform. A different choice model would be one that allows boards or audit committees (as elected representatives of shareholders) to decide the level of fraud detection intensity. A key advantage of allowing investors or the board or the audit committee to choose the fraud detection level is that it would dispense with a 'one-size-fits-all' approach to fraud detection, instead encouraging a model that is tailored by the investors' perceptions of the company.

In addition, the possibility that the relevant decision-makers might vote at any time to conduct a forensic audit could act as a powerful fraud deterrent to the management and its employees.

The 2006 amendments to the Chartered Accountants Act resulted in the setting up of a Quality Review Board (QRB) entrusted with the task of reviewing the quality of services (particularly audit services) by statutory auditors in India. The functions of the QRB include making recommendations to the Council for quality of services; reviewing the quality of services (including audit services); and guiding members to improve the quality of services and adherence to the various statutory and other regulatory requirements.

The Council of the ICAI has implemented a Peer Review from 1 April 2003 directed at the attestation services of the firms registered with it. As and when QRB becomes operational, it would be expected to manage the peer review mechanism.

It is unclear whether the QRB would only make recommendations with regard to quality of audit services or whether it would have ultimate powers on inspection and discipline. It is also unclear if it will have a majority of non-practising members—a prerequisite for recognition as equivalent by the EU or the PCAOB for home country reliance.[6] Accordingly, appropriate independent regulatory oversight in India should be implemented to avoid unnecessary duplicative costs and potential conflicts of law. Further, public confidence is best served by external independent review of audit firms and selected audits. The lack of such reviews is a significant weakness in the operation of Indian capital markets.

The current situation in India is replete with artificial restrictions on the number of audit clients of a firm. The Indian Companies Act does not specify a limit on the statutory audits of private companies. However, the ICAI has capped the permissible number of statutory audits (including private companies) per partner to 30 (which is called a “self-regulatory measure”). Audit firm rotation rules are applicable for Indian banks (every four years) and audit firms are restricted to auditing no more than four private banks by the RBI. The Indian insurance regulator, IRDA, has laid down a maximum of two statutory insurance company audits per firm in addition to firm rotation. Given the specialist expertise needed for effective banking and insurance audits (in addition to the resources and skills required to carry out these large engagements), the restrictions represent a significant risk to audit quality. Companies should be able to choose an audit firm which is best able to serve them and their stakeholders without the impediment of these artificial restrictions. Despite support from Indian corporate entities, there has been no change to these arbitrary restrictions.

The *appearance* of independence in the audit function is important. However, comprehensive knowledge of the nature of the organisation’s business is critical to audit quality. Some observers and regulators from the accounting profession in India have suggested that the independence of audit firms and the effectiveness of audits would improve only if mandatory audit firm rotation were introduced. And the choice regarding whether or not to have joint audits should be left to audit committees and shareholders, and should not be mandated by regulation.

Regulators

The framework for regulatory compliance and the processes of oversight that regulators have in place are fundamental in the context of achieving good standards of governance at a macro level. For regulators to be more effective as reputational agents, it is essential for them to implement a strong institutional framework to monitor oversight and enforce compliance, engage in dialogue, share good practices, and encourage institutional activism.

A key objective of regulation in a corporate governance context is the protection of investors in general, as well as absentee shareholders and shareholders who are not in operational control in particular. Shareholder interests are safeguarded through mandates that promote fair play, transparency, and disclosure.

Regulators who issue detailed corporate governance guidelines to companies should periodically assess whether the regulations lead to holistic improvements in corporate governance practices and whether companies actually benefit in terms of improved performance, compliance with regulations and effective management of risks. The recent financial crisis led to intense debates on the adequacy of current corporate governance regulations in India and elsewhere. The role of regulators is particularly critical in this context.

Many regulators across the globe have adopted a 'one-size-fits-all' approach to corporate governance. The problem with this approach lies in its granularity and a compulsion to carry out the same set of actions in dissimilar situations. This often results in a box-ticking approach to governance and the underlying spirit of the regulations gets sidelined. In the context of corporate governance, regulators can enhance their reputation with stakeholders and thereby improve the overall standards of governance by essentially focusing on the adequacy of existing regulations; current practices in monitoring and regulatory oversight; and the role of institutions in promoting institutional activism.

Current scenario

Governance regulations and codes around the world have been either principles-based or rules-based. The regulatory system in the US is based on strictly enforced rules. In contrast, the UK adopts a principles-based governance model on a 'comply-or-explain' approach, where it is not necessary for companies to comply with all aspects of the code so long as they satisfactorily explain the justifications for their non-compliance. In response to the financial crisis, regulators around the world have responded by introducing a fresh wave of regulations.

Whether corporate India, which follows a rules-based governance structure, is complying with regulation merely in letter is a question that is often raised. This is particularly significant as the nature of corporate India's approach to compliance and regulation exerts a sizeable influence on the quality of compliance. While a vast majority of Indian listed companies comply with Clause 49 of SEBI's listing agreement, whether the quality of corporate governance is acceptable or not is a matter of debate.

In the ambit of Clause 49, corporate governance requirements fall broadly under two categories—mandatory and non-mandatory. Unlike governance codes elsewhere, it is not mandatory in India to put in place whistle-blower policies, board evaluations, nomination committees, and remuneration committees. However, these provisions are vital to protect the interests of non-promoter groups. Fortunately, the trend today is encouraging because sincere regulatory efforts are being initiated to supplement existing rules with broad-based governance principles. While there is no documented evidence suggesting principles-based governance as a mechanism mitigates financial crises and unforeseen contingencies in every respect, there is a strong case to contend that principles-based governance has a crucial role to play in boosting organisational performance.[7] Further, a principles-based approach to governance promotes substantive equality, reduces arbitrariness, and helps companies adapt to an evolving environment Ford (2008, p. 7).

Corporate governance standards in promoter-driven, family-managed businesses remain a concern for institutional investors. The Ministry of Corporate Affairs has played a significant role in taking concrete steps to improve the corporate governance standards in India Inc through a two-pronged approach—strengthening the corporate governance provisions within the Companies Bill 2009 (proposed) through greater transparency in disclosures and enhanced powers to shareholders; and introducing the voluntary guidelines on corporate governance based on best practices that listed entities are encouraged to adopt. Although voluntary, companies are expected to adopt the guidelines using a "comply or explain" approach which implies that companies are expected to transparently disclose the

extent to which they have implemented the guidelines and the reasons for non-adoption of certain guidelines.

Key improvement levers for better regulatory oversight

Regulators would become more mature in their role as reputation agents if they seek out and internalise key insights from international experience on how companies that pursue various corporate governance prescriptions perform as against their peers who adopt a more principles-driven approach. What India needs desperately is to strengthen regulatory oversight. Four key areas of improvement have been identified to strengthen regulatory oversight—monitoring the quality of disclosures; oversight of audit quality; monitoring the implementation of corporate governance norms; and cultivating the trend of regulators' dialogues with institutions.

(1) Monitoring quality of disclosures: In India, SEBI's monitoring of disclosure requirements could be far more effective if it were to establish an exclusive regulatory agency to monitor the consistency of company disclosures, like the Financial Reporting Council (FRC) and the Financial Reporting Review Panel (FRRP) do in the UK. The regulatory methodology currently adopted can become increasingly valuable if SEBI ties up with independent monitoring agencies that discharge their regulatory oversight responsibilities, freeing SEBI to focus on the strategic components of corporate governance regulation.

(2) Oversight of audit quality: To cover the audits of listed companies incorporated in the UK, the FRC has constituted an Audit Inspection Unit (AIU) as a part of the Professional Oversight Board, which supports the FRC's objective of investor and public confidence in the financial governance of business organisations. The rationale behind the FRC's regulatory approach lies in facilitating strong connections between the issues of corporate governance, audit, actuarial practice, corporate reporting and professionalism of accountants and actuaries. This would be a good model for India to adopt.

(3) Monitoring implementation of corporate governance norms: Regulators have a crucial role to play in terms of monitoring how companies

implement the corporate governance norms in spirit. To be effective in their roles, and also in the context of enhancing their reputation with stakeholders, it is vital that regulators take proactive measures to identify corporate wrongdoing and identify instances of non-compliance that need to be dealt with firmly. There are several important prerequisites for achieving this objective—provisions within the legal system to penalise wrongdoers, including the severity of penalties; flexibility within the legal system to facilitate and enforce swift action; the extent of coordination between multiple agencies (e.g. SEBI, stock exchanges, and financial reporting oversight bodies such as the QRB); and the extent of dialogue between institutions and the regulators.

In comparison to some of the developed markets (notably the USA and the UK), India lags behind on each of these four aspects. In a corporate governance poll undertaken by KPMG in 2009, a vast majority of the poll respondents indicated that the quality of regulatory oversight in India is a much bigger issue than the adequacy of regulations. Despite the presence of stringent insider trading rules that date back to 1992, India has had very few instances of prosecution for insider trading. In recent times, we have seen non-compliances with Clause 49 of the SEBI listing agreement by several large listed Public Sector Units, yet neither the market regulator nor the government has come up with stringent sanctions, much to the detriment of stakeholders.

(4) Regulators' dialogue with institutions: There is an urgent need in India to cultivate and develop institutions that can play the multiple roles of industry watchdogs, undertakers of governance research aimed at disseminating good practices, and institutional activists in the context of protecting the interests of retail investors. In the US, bodies such as the Council of Institutional Investors, the Millstein Center of Corporate Governance (a part of the Yale School of Business), the Director's Institute, and the National Association of Corporate Directors (NACD) have been playing a critical role by introducing much needed changes to governance practices.

What could benefit India is a mechanism where regulators actively engage with industry bodies, professional and academic institutions, governance research centres as well as governance practitioners like independent directors, shaping the future of governance regulations and good practices.

It is desirable for SEBI and the stock exchanges to engage in an active dialogue with institutional investors, ensuring that their concerns and viewpoints are reflected in the way the amendments are made to future corporate governance codes. This would instil confidence in institutional investors on the role of Indian market regulators, resulting in a culture where governance requirements would be taken more seriously. A strong culture of shareholder activism would also result in industry adopting best practices voluntarily.

Internal auditors

The role of internal audit is evolving to focus on value creation instead of mere value preservation. Today, internal audit is required to meet the expectations of audit committees and to proactively help CEOs and CFOs to improve business processes, and to tackle emerging risks. A sharp line of distinction can be drawn between the role of internal auditors and that of independent auditors on the basis of the broad and crucial responsibilities that internal auditors are entrusted with, i.e. to support company boards and management in their risk management and strategy implementation efforts. Internal auditors are required to be independent and positioned appropriately to address the needs of multiple stakeholders.

The importance of internal auditors as reputation agents

The key role of internal audit lies in discharging its governance responsibilities by delivering a review of the organisation's culture and adherence to its code of ethics; an objective evaluation of the existing risk assessment and management processes; systematic evaluations of business processes, associated controls, and their linkages to risk areas; review of the existence and valuation of assets; source of information on major frauds and irregularities, including periodic assessment of fraud

risks; review of regulatory compliance; and special and ad hoc reviews in new emerging risk areas or specific concerns flagged by the board and senior management.

Internal auditors have a moral duty to companies, their boards and shareholders. The business problems that they are instrumental in identifying can potentially generate adverse media coverage if they become public. The effects of such adverse coverage can result in fines, penalties, unbudgeted expenses, and unsolicited scrutiny—developments that can seriously damage an organisation's reputation. Today, corporate boards are increasingly turning to the internal audit function to partner in their oversight efforts. CEOs and CFOs expect their internal auditors to move from a controls-and-compliance-centric approach to one that is risk-centric.

Current scenario

The unique focus of internal auditors on risks and controls is vital to good governance and financial reporting processes within organisations. Independent auditors provided no qualifications in the annual financial statements of over half of the 673 US public corporations that faced catastrophic bankruptcies since 1996 (Rosenfield, 2008). The organisations that succumbed to the largest bankruptcies (including Enron, Global Crossing, and Kmart) produced annual reports with clean audit opinions from their independent auditors. This demonstrates the increasing level of difficulty that independent auditors, boards, and managements face in developing an accurate picture of organisational risks and controls. It also draws attention to the vital role that internal auditors could play in shaping governance processes by assessing the effectiveness of organisational risk management regimes and apprising the board, senior management and external auditors of the risks and control issues that an organisation faces. In this context, a growing trend is for large corporations to supplement their in-house internal audit functions with co-sourcing arrangements whereby specialist external resources are used to review specific risks (Cashell, 2003). A survey conducted jointly by KPMG and the Bombay

Stock Exchange in 2009 highlighted several challenges for the internal audit function (KPMG, 2009).

Key improvement levers

The expansion in the scope of internal audit from a focus on conventional checks and balances to an overview of diverse functions that span process improvements, cost optimisation, a risk-based approach and revenue assurance through the identification of revenue leakages, will go a long way to enhance corporate value. A number of improvements are essential to achieve this transformation.

(1) Positioning and independence of internal audit: Since its status within an organisation determines its effectiveness as a reputation agent, internal audit should be strategically positioned within the business to enable it to contribute to business performance. The role of internal audit has evolved as a major risk management tool to involve much more than just checking numbers and vouching invoices.

Independence and objectivity are critical components of an effective internal audit function. The independence of internal audit is a prerequisite to tackle governance failures and to tackle the tendency of owners and managers to override internal controls. Moreover, internal auditors must maintain a high level of objectivity by ensuring they have no vested interest in the areas they are auditing. In addition to such professionalism, it is important to operate with an unbiased and impartial mind. In this regard, it is important to raise the profile of internal audit in an organisation.

Audit committees need to be more involved in all operational aspects that encompass the coverage, skill-sets, appointment processes, remuneration, and performance of internal audit (Braiotta, 2002).

It is important for the Chief Audit Executive (CAE) to be treated on par with other senior executive positions and to have a say in matters of strategy, risk and regulatory compliance. More importantly, the CAE should have the freedom to question any level of management about their activities and compliance with organisational policies and risk thresholds.

To achieve this, the CAE should have direct access to the CEO and audit committee.

The internal audit charter should establish the independence of the internal auditor by calling for a dual reporting relationship to the management and the audit committee. The reports to the executive management are useful when assistance is required to establish direction, support and an administrative interface. Such a reporting structure would help the audit committee in its strategic direction and accountability. Further, internal auditors should have unfettered access to records and personnel as and when these are deemed to be necessary for their audits. They must also be allowed to use appropriate probing techniques without impediment.

Direct channels of communication between the CAE and the audit committee reinforce the organisational status of internal audit and facilitate access to organisational resources while ensuring independence is not impaired. This approach provides sufficient authority to achieve broad audit coverage and adequate consideration of engagement communications. Independence is further enhanced if the CAE reports to the board through the audit committee on the planning, execution and results of audit activities. The audit committee should be responsible for appointing, removing and fixing the CAE's compensation. The audit committee should also safeguard the internal auditor's independence by periodically approving the internal audit charter and mandate.

(2) Skill-sets of internal auditors: Internal auditors must move away from a traditional audit approach to one that is centred on a risk-based annual audit plan, and is constantly updated based on the changing risk profile and stakeholder expectations, and operates within the contours of a nimble and flexible scheduling and planning model.

In view of the impact of globalisation, technological advancement, and risk management changes, there is the added challenge of re-tooling internal audit skill-sets to include people with experience and skills in the use of data mining and analytical tools as well as people with specific

talents given the myriad of risks highlighted above. Internal auditors should be increasingly using technology-driven tools to transform traditional approaches when they conduct audits.

It is also critical to adopt "continuous auditing techniques" as greater assurance can be provided more quickly at substantially lower cost. Today's boards and audit committees are looking at real-time assurance based on the coverage of large volumes of data, rather than small sample sizes. The use of continuous auditing and monitoring tools is therefore essential if internal auditors are to be more effective in providing real-time assurance.

(3) Performance and accountability of internal auditors: Of the many factors that have surfaced as causes of weak governance structures in India, the lack of accountability of the internal audit profession, along with poor internal auditing standards, have emerged as the more controversial ones. To maintain accountability, it is important to establish objectivity in the course of any internal audit engagement.

In this context, KPMG's 2009 Internal Audit survey highlighted that only 31% of all Indian organisations were undertaking a focused performance evaluation of their internal audit function. Most internal auditors in Indian listed companies do not seek feedback from their key stakeholders either after completing their internal audits or before issuing internal audit reports. Hence most Indian companies lack an effective framework to assess how they are delivering internal audit engagements, and also whether the intended assurance objectives are being met.

From a broader reputation perspective, disclosure aspects related to internal audits should be revisited. Presently, the Companies Act 1956 requires statutory auditors to report whether companies have an internal audit function that is adequate in the context of the business and commensurate with the size of business operations. However disclosures in the Auditor's Reports are vague and do not provide stakeholders an objective view of the robustness of the internal audit function. Global governance failures have time and again led to a flurry of questions in

connection with the role of external auditors, their scope of audit and the quality of their disclosures in audit reports. A similar scrutiny of the internal auditors would prove worthwhile.

Rating agencies

Rating agencies are reputation agents because many investors base their decisions on the agencies' certifications and assurances with regard to rated securities, and also the way they rate other corporate practices.

The importance of rating agencies as reputation agents

A rating agency is required to publicly disclose the percentage of net revenues attributable to the largest users of credit rating services and also the percentage of net revenues (of the rating agency) that are attributable to other related products and services of the agency. On the global front, credit ratings have evolved in their role as reputation agents over the years, more recently gaining acceptance as convenient tools for differentiating credit quality (Standard & Poor's, 2002). Globalisation and the advent of Basel II (which incorporated ratings into rules for setting weights for credit risk) gave credit rating agencies a further boost (Elkhoury, 2008).

The role of credit rating agencies in India has grown phenomenally in view of the expansion in the volume of issuance. Another encouraging trend is the increasing level of reliance that investors and regulators have begun to place on the ratings provided by these agencies. In recent times, the role of credit rating agencies as reputation agents is also gradually becoming more interrelated with the roles of regulators and internal auditors because credit rating agencies have begun playing a more instrumental role in helping achieve the regulatory objectives of investor protection, transparency in markets, and the mitigation of the occurrence and/or impact of systemic risks.

Current scenario

Credit ratings in India have been operational for over two decades. CRISIL (Credit Rating and Information Services of India Limited) was the first rating agency that was set up. India presently has five registered

rating agencies—CRISIL, CARE (Credit Research Analyst Ltd), ICRA (Investment Information and Credit Rating Agency), Fitch, and Brickwork Ratings India.

SEBI's regulations (1999) provide various guidelines with regard to the modus operandi for the registration and functioning of credit rating agencies in India. The registration procedure includes a strict examination of the details provided by rating agencies in their application for the establishment of their agencies in India. Credit rating agencies are also provided with compliance officers to whom they are required to share their accounting records (SEBI, 1999). In the ambit of the Indian regulatory framework, credit rating agencies are required to abide by the Code of Conduct contained in the Third Schedule.

As per SEBI's guidelines, the requirements that rating agencies in India, are to (1) continuously monitor the ratings of their securities; (2) frame appropriate systems and procedures to monitor the trading of securities; (3) share information on newly assigned ratings and/or changes in its earlier ratings, through press releases and websites; (4) supply information on new rating developments, to the regional stock exchanges that a rating agency operate in and all other stock exchanges where there securities are listed (in the case of securities that are issued by listed companies in India); and (5) conduct periodic reviews of published ratings during the lifetime of the securities that have been rated

In January 2010, SEBI mandated that credit rating agencies should have internal audits, to be conducted on a half-yearly basis, covering all aspects of credit rating agency operations and procedures including investor grievance and redressal mechanisms.[8] The key rationale behind this measure was the evaluation of the adequacy of systems adopted by credit rating agencies to comply with regulatory requirements, the rectification of existing deficiencies (if any), and the reduction of the incidence of violations observed.

Key improvement levers

More transparency is required for the accuracy of additional information on the magnitude of any existing or impending conflicts.

Secondly, the excessive process orientation of credit rating agencies worldwide tends to undermine their role as reputation agents. For instance, Standard & Poor's (S&P) had committed to integrating enterprise risk management (ERM) into its rating process for non-financial corporations. S&P, which views ERM as a tool to assess management, expects to complete its ERM criteria with a view to including an analysis of ERM structures in its overall ratings of non-financial entities. S&P hopes that the inclusion of ERM factors into its credit analyses will improve the overall quality of ratings by enhancing its opinions on the management of corporate borrowers (Aon Global Risk Consulting, 2009). Seeking to revise its rating process in 2009, S&P ran into delays as the result of the financial crisis and an impending need to complete a series of additional in-depth interviews with companies on the theme of their ERM capabilities.

However, one of the pitfalls associated with S&P's approach is the complexity of the process. Having met with the CFOs of the companies they interviewed, rating analysts found that ERM responsibilities may lie elsewhere and not with CFOs or treasurers. S&P has presently undertaken about 300 ERM interviews with non-financial companies. However, this number represents only 10% of the companies that are otherwise rated by S&P (Towers Perrin, 2009). This sample is too small to publish any formal criteria. On such occasions, transparency and external validation of new criteria do not suffice. It is essential to have strong internal acceptance of new criteria within rating agencies too. In this context, it is the degree of comprehensiveness in the approach adopted by rating agencies to publish their statements or fine-tune their oversight capabilities that would strengthen their role as reputation agents.

A more valuable way of benchmarking companies would involve framing clear yardsticks for different rating parameters and evaluating companies on the basis of these benchmarks for each rating parameter. Since ratings are integral to a company's reputation, this approach will most likely sharpen the focus of companies on their own internal benchmarking practices, performance and reputation management efforts.

The media

The media is instrumental in influencing and mobilising public opinion and market perceptions of the performance and corporate affairs of organisations. While it is vital for Indian listed companies to develop and maintain effective and sustainable relations with the media, both in India and abroad, the advent of social networking sites and the shift in power from media producers to media consumers demonstrate the growing importance of the media as reputation agents. A classic example of the impact of the media on corporate reputation is the ability of public critics to broadcast their complaints and opinions of companies and their products and services around the world via the Internet.

The importance of media bodies as reputation agents

In this paper we will limit the definition of media to comprise corporate entities, publishers, journalists, and reporters who constitute the communications industry. The media is a powerful agent in disseminating public opinion and inducing a change in the mindsets of the public by altering their perceptions through representational communication modes. Such representational projections of corporate bodies and the brands associated with them have a direct impact on corporate reputation. The various sections of the media are crucial in their role as reputation agents as they serve as liaisons between organisations and their publics. Dyck et al. (2008) observe that the media serves an integral role specifically in absorbing the cost of gathering information (from companies) that would benefit shareholders.

The onus on the media to unravel corporate governance issues is large, especially in situations where regulatory mechanisms to protect investors are relatively weak.

Current scenario

The media can be extremely effective in its role as a reputation agent in view of its capacity to build an image of the culture and identity of a corporate entity behind the face of its brands, products, and services. However, the role of the media is typically influenced by the corporate

communications efforts that organisations initiate. Today corporate communications has become an art of perception management. The focus of corporate communication professionals has been extended to include the need to develop a strong base of reputation capital and build positive relationships with the media. The drawback associated with the creation and sustenance of a strong relationship between corporate communication/PR professionals and the media is that there is a possibility of the existing and/or impending corporate governance glitches and accounting shenanigans being overlooked by the media or bring reported mildly, until these grow to such an extent that they impact the economy and/or become world news.

In India, corporate governance issues appear at the forefront of media reports and broadcasts only after the occurrence of a major governance scandal. The obsessive focus of the print and electronic media on the quarterly earnings of Indian listed companies is another example that typifies the media's one-dimensional focus on financial performance. Specifically in the context of corporate governance, the role of the media can at best be termed as reactive.

What exacerbates this state of affairs is the relatively poor media regulatory framework in India. When compared with the UK and the US communications regulatory structures (which are strong and well-defined, even while being different from one another), the media governance standards in India are inadequate. The Office of Communications (Ofcom)[9] in the UK ensures that media consumers get satisfaction from the media and communications services that they are provided. The communications regulator also protects individuals and companies from privacy intrusions, scams and fraudulent practices while simultaneously encouraging competition. While Ofcom regulates the television, telecom and mobile convergence sectors, the Press Complaints Commission (PCC) serves as an independent self-regulatory body to deal with complaints and disputes about the editorial content of newspapers and magazines and their websites. The PCC also trains journalists and editors, working proactively to prevent media intrusion and falsified media reports. Additionally, pre-publication advice is provided to journalists as well as the public.

The US communications industry is monitored by the Federal Communications Commission (FCC),[10] which regulates interstate and international communications via television, radio, wire, and satellite. The FCC handles a wide range of concerns ranging from consumer and governmental affairs to media issues.

In striking contrast, the closest full-fledged regulator that India has to monitor the communications industry (or rather a part of it) is the Telecom Regulatory Authority of India (TRAI). India does not have the equivalent of Ofcom or the FCC. Even while broadcast regulatory measures have been discussed by the Ministry of Information & Broadcasting, the urgency to initiate any action appears to be diluted by other more important predicaments on the Ministry's agenda.

Key improvement levers

Companies should move beyond the contours of basic media monitoring, which is largely focused on merely calculating the number of significant mentions of a company and/or its related brands, products and services across varied media reports. It is recommended that companies devise a suitable mechanism to track the effectiveness of their campaigns, marketing efforts, and representations of their brands.

A greater degree of efficiency in the public relations efforts of companies is vital to facilitate direct communication with the media to ensure good governance and human rights.

In its capacity as a watchdog of accountability and transparency, the media must impartially disseminate news and create transparency in corporate entities.

The Indian media needs to have a more sustained form of reporting. It is important for business journalists and newscasters to discuss corporate governance and risk management issues as part of their regular discussion and reporting.

In analysing corporate performance, the media should also focus on other important aspects such as investor relations and communication

practices, the quality of corporate boards and companies' adherence to environmental, labour and ethical standards (e.g. safety, sustainability and communities). Editorials have begun to publish comprehensive and insightful articles on corporate governance. However these continue to be few and far between. The subject of corporate governance can receive more prominence in the media if specialists and laymen simultaneously engage in stimulating debates on those issues of foremost significance to Indian listed companies—transparency, accountability, governance, and shareholder activism.

The Indian media needs to portray a balanced picture of current societal needs and the role of corporate bodies in catering to these needs. To this end, it is also essential to project companies on the basis of a triple bottom line approach that highlights the social, economic, and environmental contributions of companies instead of focusing merely on companies' financial worth.

There is a need for self-regulatory provisions to propagate a culture of sustained media reporting/broadcasting and infuse balanced, responsible and more pluralistic journalism in India. An independent self-regulatory mechanism is necessary for the media to be effective and powerful in their role as reputation agents for Indian listed companies as well as the larger shareholder communities and members of the general public.

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Notes

[1] The sections on regulators, rating agencies, and the media were developed from KPMG's thought leadership publications and research reports.

[2] A simple agency model of audit is a structure which is characterised by the introduction of an expert independent auditor and the execution of a statutory audit, which is intended to help address simple agency conflicts between a company's shareholders and directors. See Institute of Chartered Accountants in England and Wales (2005, p. 9).

[3] The earlier version of the ICAI's Code of Ethics included only "gross negligence" under the purview of professional misdemeanour.

[4] While rotating audit firms is useful in enhancing the independence of audits, it has its pitfalls too. For instance, it could erase the cumulative knowledge of an audit firm, and reduce audit effectiveness, and it increases business costs and reduces efficiency.

[5] The standard was recommendatory for all engagements relating to accounting periods beginning on or after 1 April 2008, and became mandatory for all engagements relating to accounting periods beginning on or after 1 April 2009.

[6] The current construct of the QRB is unlikely to meet the membership criteria of the International Federation of Independent Audit Regulators (IFIAR).

[7] For more details, see Leadership Acumen (2004).

[8] See The Economic Times Bureau (2010) for more details.

[9] Ofcom is an independent communications watchdog, which operates under the Communications Act, 2003 in the UK to propagate media ethics and further the interests of the UK's citizens and consumers. Incidentally, Ofcom is entirely independent from the Government.

[10] Established by the Communications Act of 1934, the Federal Commission of Commission (FCC) is an independent United States Government communication agency. The FCC's jurisdiction covers 50 states, the District of Columbia and the U.S. possession. Though a Government agency, it retains its independence in every sense.

14

The Institution of Independent Directors: Does it really Deliver?

Prithvi Haldea

This paper is predicated upon the premise that the institution of independent directors (IDs) need not have come into existence at all if the promoter and executive managements had not unduly enriched themselves at the expense of the minority shareholders, and had instead embraced fair and ethical practices.

1. Introduction

The role and responsibility of independent directors (IDs), which have been under debate for several years, have now come into sharp focus after the failure of many high profile corporations around the world; in India, the Satyam episode was the eye-opener, so to speak. While many brush aside Satyam as a one-off aberration, Satyam is in fact a watershed event for the institution of IDs. What makes the event of Satyam relevant is that it was possible for a huge scam to be perpetrated, and that too over several years, under the very eyes of some of the most reputed and competent persons (four highly successful and renowned academicians, an accomplished retired cabinet secretary of the Union Government, and a world-renowned technological genius) serving on its board as IDs.

If the institution of IDs which is the supreme surveillance body cannot even begin to detect such a huge fraud, what purpose does it serve in protecting the interest of the non-promoter shareholders? If the stranglehold of a majority of the promoters on their companies is so overwhelming that even highly credible, qualified, and educated persons are not willing to

or able to discipline the promoters who appointed them to the board, and tend to trust and provide blind support to the promoters, how then can they collectively act as watchdogs and protect the interests of the non-promoter shareholders they are primarily supposed to serve? This is an inherent paradox of the institution of IDs.

That more scams have not come to light could be due to several reasons—poor surveillance, the absence of more confessions of crime by the promoters, the ineffectiveness of whistle-blowing, and so on. It may not be necessarily because the IDs in other companies have been more diligent and have prevented scams. It would therefore be incorrect to assume that overall the institution of IDs is working well in India. Globally also, the role of IDs is now increasingly being questioned.

2. Independent directors: The institutional context

Multiple owners or shareholders of companies who are not in operational control require some mechanism to look after their interests and preempt any expropriation by those in operational control—hired executives or other co-owners. Such a group of people meant to exercise surveillance over the managers and controllers necessarily need to be free from any influence or dependence upon them, and these imperatives led to the evolution of a set of directors on company boards, who were variously referred to as independent, outside, non-executive, non-aligned, and so on. It is of course relevant to note that the job of such directors is not merely surveillance (important as it is); their controlling and monitoring role also continue to exist.

Rationale for Independent Directors

The concept of corporate governance (CG) came into existence due to the regulators' desire to preempt the natural human tendency of the promoters and/or the management for undue enrichment at the expense of the minority shareholders, and to discourage non-compliance with laws and regulations. If almost the entire foundation of CG were to rest on the shoulders of the institution of IDs, it must be robust enough to discharge that

onerous responsibility. But the moot question is whether this institution is strong enough for the job. Regrettably, it seems overly fragile especially in a context like India which is predominantly promoters-controlled. In fact, it may now be playing a negative role by providing a false sense of security to investors and regulators.

It is interesting that although CG and IDs have been publicly debated over the past several years, of the nearly 3,000 listed companies that are governed by Clause 49, only a handful like Infosys, Tata, Godrej, HDFC, Hero Honda, Wipro, M&M and Max continue to be cited even now as role models. The reality is that these cited companies would most probably have had good CG even without Clause 49, because their promoters are people with the right value system, who have passed on those values across their organisations. But this is not true of the vast majority of companies. This debate has to be extended to the entire listed world. Failure to do so will make capital scarcer, hurting the growth of the economy.

Significantly, no strong voices of dissent have been heard from the corporates themselves decrying the ineffectiveness of the system of IDs. Most of them in fact appear to be comfortable with the present state of affairs, even proclaiming that Clause 49 is near perfect, and that no additional regulatory burden should be imposed.

Additionally eminent and respected persons, who are IDs themselves, have written, spoken and debated in defense of the present institution of ID. But they speak from their own personal experiences, and they represent at best a small minority of the listed companies. Interestingly, many of these eminent persons have now started admitting in public that if the promoter of a company and its CEO/CFO are intent on committing a fraud, there is little an ID can do to detect, mitigate, or prevent it. Could it be that much of this defence of the institution of ID in its present format is self-serving?

The promoters themselves also possibly recognise that IDs are a myth but they are happy to go along with the institution in its present format since it offers them an aura of approbation without inflicting any major interference in their usual operations.

Following the Satyam incident, some recommendations were made in the Voluntary Guidelines on Corporate Governance issued by the Ministry of Corporate Affairs (MCA), and in the Naresh Chandra Committee Report on Corporate Governance. Though many of the recommendations are significant steps forward, many of the fundamental deficiencies are yet to be addressed. Moreover, a voluntary code may not be taken very seriously, and any explanations for non-compliance would generally be innocuous and subjective. Regulators, institutional and minority shareholders and other stakeholders therefore need to demand the necessary mandatory changes.

Defining the role of independent directors

It would be appropriate in this context to define the institution of IDs especially in the Indian context, which becomes even more relevant in the face of the attempts that are being made to redefine and dilute the role of IDs, in order to include contribution to the development of corporate strategy, and review of the performance of the management in meeting the agreed goals and objectives, and value addition to the company in various other areas through their knowledge. While all these may be relevant in more developed markets with diversified corporate ownership, none of these could be the primary roles of the IDs in India with its predominantly concentrated ownership structures. It should also be recognised that IDs are mandated only for the listed companies. Even the voluntary guidelines of the MCA do not consider it necessary to mandate independent directors for the unlisted public limited companies (approximately eight lakh such companies exist in India), let alone other incorporated entities. This is essentially because only listed companies raise money from the public. The fundamental and primary perceived role of IDs in India therefore is simply the protection of public shareholders through means that would include opposing ideas that are detrimental to their interests, establishing financial controls to ensure that promoters do not enrich themselves through unfair means or excessive remunerations, and so on at the expense of the minority.

It therefore follows that anything else that the IDs do should be seen only as a desirable extra but not at the expense of their primary role of surveillance, and monitoring of the controlling promoters and managements.

The only real meaning of "independent" in this context would be that such persons should be independent of the promoters and the management so that they are able to protect the minority shareholders from the promoters.

This position is also supported by the fact that no one has ever complimented IDs for good business decisions or questioned them for the wrong ones. Even if adding value was an unstated objective, it would only be met partially (if at all) as not many IDs would have the necessary domain knowledge and expertise.

Appointment of IDs

If indeed the role of the ID is to protect the minority shareholders from the promoters, prudence would dictate that their appointments be made by someone other than the promoters. The reality and the irony however is that in India, the selection and appointment of IDs is entirely in the hands of the promoters.

Even in the few companies with Nomination Committees, the selection process—barring limited exceptions—is largely influenced by the promoters and management, especially since there is no requirement that such committees should wholly consist of independent directors, or that such meetings should be held in executive sessions without promoters and managements being present. The director selection processes are also very deficient—candidates are initially appointed as additional directors (for which no shareholder approvals are necessary) and are then processed through the next general meeting. No prior approval of the shareholders is required. The problem of appointment of IDs by the promoter could have at least been partly mitigated if some stringent eligibility and entry norms had been prescribed. Sadly, there is not a word on this mentioned in the entire regulation.

3. Issues related to compliance

After several extensions, the deadline for compliance (requiring 50% of the board to be composed of IDs) was finally extended in March 2005 to 31December, 2005. On expiry of the deadline, almost all companies

filed full compliance.[1] On closer scrutiny however, the *modus operandi* was as ingenious as it was simple—hundreds of companies just re-labelled their incumbent directors as independent. The second device was equally innovative—the regulation permitted a reduced one-third of the board to be independent if the board chair was non-executive. In as many as 30% of the companies, promoters or promoters of the promoter companies or even their relatives re-designated themselves as non-executive chairmen to qualify for this well-intended relaxation, thereby reducing the number of independent directors they were otherwise obliged to have. The net result of these actions was an apparently high level of compliance, in letter though not in spirit.

Does Clause 49 promote board and director independence?

In addition to these compliance machinations of the corporate, there are the grossly inadequate regulatory provisions with regard to independence of directors and boards—many concessions and compromises were made while framing the mandatory requirements bearing upon director independence (as indeed on many other aspects of good governance). The result is a fairly relaxed regulatory regime, whether in terms of rigorous prescriptions or their effective monitoring for compliance. For instance, *relatives* as defined in the regulations cover only a very few persons. It was (and is) therefore possible for companies to appoint several of their close relatives (who are outside the narrow definition of relatives in the Companies Act) to the board, and they will technically qualify as independent. While anyone related to the promoters is not considered independent, relationships between and among IDs does not carry such a disqualification. Moreover, there are no guidelines on the minimum board size. Many companies have very few directors, and as many as 22% of the companies which reported compliance have just one or two IDs on their boards, while still being compliant with the regulations. For the first two years, no age limit was prescribed for IDs. In 2007, it was found that over 150 young people (some of them barely 18) were on the boards of companies as IDs. It is highly unlikely that someone so young could add value as an ID of a company.[2]

At the other extreme, around 3305 IDs (i.e. 48% of the total number of IDs) were above the age of 60. Significantly, of these 3305 directors, 1541 (22%) were above the age of 70233 were past 80, and 7 were older than 90 The 1541 individuals who were 70 years or older, held as many as 2337 ID positions. Their physical and mental fitness can at best be open to speculation.

To make matters worse, there are no norms on educational qualifications/ knowledge prescribed. 35% of the ID positions are held by graduates or lesser qualified individuals. Of these, as many as 240 ID positions are held by persons who are not graduates, of which 136 individuals do not possess any college/university education whatsoever. While education by itself cannot be the sole qualifying criterion, it is indisputable that it does expand the knowledge and querying capabilities of an individual.

The limit on the maximum number of ID positions an individual can hold is too high. The Companies Act puts a ceiling of 15 directorships of public companies, making no distinction for listed companies. It is beyond debate that listed companies demands a much greater degree of commitment from an ID, including the attendance of at least four board meetings and several meetings of one or more of the many committees during a year. How many IDs can play an effective role in the listed companies has been a moot question. As of 31 December, 2009, as many as 280 individuals held 5, or more than 5, directorship positions in listed companies, in addition to directorships in several unlisted companies.[3]

The maximum number of all directorships (listed/unlisted/foreign companies) held by any one individual was 101. Of the 6875 individuals who were IDs, 443 were on the board of 1275 foreign based companies and collectively, were also on the boards of 13285 unlisted companies/ organisations. In all, as such, they occupied a total of 26384 directorship positions in 15558 listed/unlisted companies/organisations.

There are also several instances of promoters who are fulltime directors of their own listed companies and at the same time hold ID positions in other listed companies. As of 31 December, 2009, there were as many as 553 such

promoters who collectively held 968 ID positions in other listed companies, and in addition held thousands of ID positions in unlisted companies.

Additionally, for the first two years, there was no guideline prescribing a time limit for the replacement of an ID in the event of a resignation, removal, or death of an existing ID. Neither was there any limit prescribed on the maximum tenure for an ID. As of 31 December, 2009, the tenure of 6,692 (75%) ID positions was more than 3 years; 3,896 (44%) more than 6 years; 2,250 (25%) more than 9 years and 1,680 (19%) more than 12 years. The highest observed tenure of an individual was 54 years.

Relaxed enforcement regime

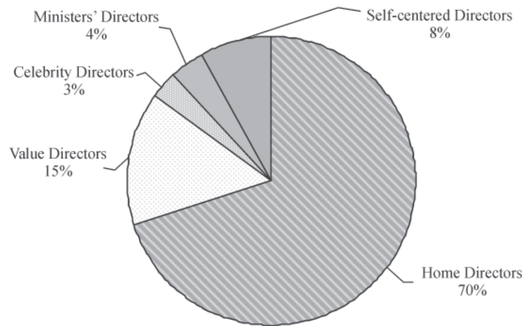
The regulatory enforcement approaches also do not seem to be stringent, rendering non-compliance by companies not a very serious failure that would invite punitive punishments. While numerical compliance as regards IDs is fully ensured by SEBI at the IPO stage, monitoring appears to weaken post listing. No action has yet been taken against the non-compliant companies, including some of the Public Sector Undertakings who pleaded that the appointment of IDs was not in their jurisdiction. As many as 20 out of the 37 listed PSUs (who have registered with directorsdatabase.com) are non-compliant in the number of IDs.

There are as many as 26 companies who do not have even one ID on their board. The only "action" taken has been to put up the names of all such non-compliant companies on the websites of the stock exchanges; a recent list includes an astounding 1,317 cases.

4. The ID profile of Indian listed corporate sector

As of 31 December, 2009, there were a total of 6,875 individuals who occupied 8,901 ID positions on the boards of 2,461 listed companies. These may be classified into five broad categories as shown in Figure 1.

Figure 1 : Categories of independent directors in Indian listed companies.



Home directors

Home directors form the major category comprising those who are known personally to the promoters such as relatives, friends, neighbours, former employees, former teachers etc. The stark reality is that no promoter would ever invite a stranger on to his board (and by the same logic, no person of any merit would accept the directorship of an unfamiliar company). A board position theoretically provides access to company confidential information that a promoter may not feel comfortable sharing with a stranger, fearing misuse.

Even if some of these home directors are qualified and competent, their home connections and sense of loyalty, and not independence, would always take precedence. An analysis of the profiles on www.directorsdatabase.com[4] shows that nearly 70% of all IDs are home members who therefore are natural allies of the promoters and whose independent status is questionable.

Value directors

This is the most visible category of IDs. Value directors are those who provide either knowledge and/or expertise to the company, like lawyers, finance professionals, and technocrats, or retired civil servants who provide networking to the company by opening doors to the government, politicians, and other institutions. Most such persons are also invited to the boards to give a sense of comfort to both the institutional as well as the retail investors.

Admittedly most (if not all) in this category are of high integrity and knowledge. The value they deliver to the company would be huge, which would also benefit the minority shareholders. But this should not be at the expense of the primary role of an ID. They are not independent as almost all such directors are also either personally known to the promoters or have been referred by someone close to them.

With their knowledge and experience, they have the ability to identify the wrongdoings of the promoters. However, such directors would still by and large ignore the same or not contest the issue beyond a point. From past experience, it can be concluded that if some value directors have ever raised their voice in the boardroom, it would probably be because the action in question may adversely impact their personal reputations.

Significantly, most Value Directors are remunerated very well when compared to their past and last earnings. This becomes significant as nearly 48% of the IDs are retired people, who naturally would be quite dependent on the ID remuneration, more so if the remuneration is high. Such IDs would be guided more by their personal economic rationale. There are also cases where an ID's earnings from a single company are as high as 50% of their total annual income, significantly eroding their independence in dealing with such companies.

An analysis of the profiles on www.directorsdatabase.com shows that about 15% of all IDs fall under the category of value directors.

Following the Satyam scandal, many value directors began to search externally for negative information (if any) about the companies of which they were board members, in order to be able to take preemptive action (by resigning) in case there was anything suspect in the activities of a particular company. Between January 8, 2009 (post-Satyam) and December 31, 2009, as many as 884 individuals holding 946 ID positions (i.e. nearly 15% of the total number of IDs) resigned, and the number is growing by the day. The biggest casualty of this exodus has been competence-the majority of resignations involved value directors, which left behind a disproportionately large number of home directors as IDs.

Celebrity directors

This category comprises people who were mainly invited to become an ID in order to add an aura of respectability and news value to the company, and also to impress the existing and potential retail investors. This category includes film stars, lyricists, sportsmen, defense personnel, fiction writers and the like.

Most people in this category are of high integrity and outstanding credentials. However, a majority of them would have very little to contribute as IDs in the commercial corporate environment. These people may not be known personally to the promoters, but since they do no harm to the company, promoters are comfortable with them.

An analysis of the profiles on www.directorsdatabase.com shows that about 3% of all IDs fall under this category.

Ministers' directors

These are people on the boards of listed Public Sector Undertakings (PSUs), who are typically appointed by the political high command or by a minister. Most of these people are either politicians who need to be rewarded, or are people who serve bureaucrats who protect the interests of the dominant shareholder—the government—or are individuals that the politicians would like to favour. The main job of such appointees is to carry out the mandate of their respective minister/ministry. Of course, some of them additionally pursue their personal agenda of benefitting from these PSUs. Such persons are clearly not concerned about the minority shareholders.

An analysis of the profiles on www.directorsdatabase.com shows that about 4% of all IDs fall under this category.

Self-centred directors

The directors nominated under a lenders' or a shareholders' agreement are treated by the regulations as IDs. In reality, these persons are typically protecting only the interests of their nominating institutions and they become "persons acting in concert" and should not as such be treated as IDs. Their role in the protection of other minority shareholders is negligible.

An analysis of the profiles on www.directorsdatabase.com shows that about 8% of all IDs fall under this category.

It is evident that none of these five categories play their primary role—the protection of the interests of the minority shareholders—essentially because they are invited to the board by the very promoters from whom the minority shareholders are to be protected. Most of them, despite being conscientious and well-meaning, may not even be fully aware of their expected role of minority shareholder protection.

Moreover, as IDs are expected to protect other people's monies, it should not be expected that they would watch over it with the same diligence and vigilance they would exercise to protect their own. It is also unreasonable to expect IDs to oversee the role and activities of their fellow directors, or to take an adversarial position. Moreover, IDs are invitees—they are guests, and guests who are also being paid. In the Indian culture, guests will always be polite to their hosts, and this further complicates matters. Given this nature of IDs, dissents are naturally rare. And given their relationship with the promoters, the rare dissent would never be made public.

As such, we believe that the entire concept of ID in the manner in which it has been defined and is practised in India is a myth. In order to test this, the following questions need to be asked. Was the ID independent of the promoter at the time of his/her appointment, and does he/she continue to be so? Is he/she competent enough to understand and safeguard the interests of the minority shareholders from undue enrichment by the promoters? The answers in most cases, regrettably will most likely be "no".

5. Way forward

We now review some of the suggestions that have been proposed in order to strengthen the institution of IDs, and then make some recommendations of our own.

It has been suggested that IDs should be elected by the non-promoter shareholders. This is fraught with unimaginable negatives. One could

see all kinds of blackmailers, people propped up by the competition, etc. coming on to the boards and destroying the companies. A suggestion has also been made that the promoters should instead create a panel and the minority shareholders should vote their choice. However, the panel would still be constituted only by the promoters and as such would still include names of insiders.

Another suggestion is that IDs should be appointed by the government or SEBI. This would lead to nepotism, corruption and unnecessary political interference.

Some experts are now exhorting IDs to become more vigilant and ask more and right questions. The reality is they would not, simply because most of them are home directors, and in any case are not competent enough. Only a few of the value directors who are knowledgeable enough, may now ask more questions. But even then, it would be more to safeguard their personal credibility.

It has been suggested that IDs should have access to information other than what is provided to them by the promoters, and they should actively seek the same directly from the functional heads. This is easier said than done; and in any case, the functional heads would be more loyal to their employer (promoter) than to the ID. Moreover, the functional heads could be suitably tutored by the promoters.

Another suggestion that has been put forward is that IDs should meet independently with the functional heads to obtain varied perspectives, which is not viable given the constraints on their time, and the lack of specialised knowledge.

Many believe that what IDs require is formal training. There are already several institutions that offer a wide variety of courses and trainings. However, such training makes little impact.

Many argue that IDs should compulsorily retire after 6 or 9 years as by then familiarity may breed complacence. However, this argument is faulty and assumes that IDs do not connive (by design or negligence) with the promoters in the first 6 or 9 years.

Another suggestion is that companies should be rated for CG. The truth is that CG is very subjective and cannot be measured through check boxes. Credit rating agencies can at best look at some visible aspects of CG like the quality of board members, their company/industry knowledge, the attendance records, quality of agenda items, minutes of the meetings, and other board room practices; but this is all about the letter and not the spirit.

It has been suggested that the quorum of a board meeting should necessarily require the presence of a majority of the IDs, or that for certain agenda items, the presence of all of at least two-thirds of all IDs should be mandated. This is again based on the premise that IDs are truly independent.

Another suggestion demands a budget for the IDs which they can use to hire the services of outside experts like lawyers, accountants, and consultants. However, since the funds would be provided by the company, there could be a conflict of interest. But more fundamentally, would the IDs (who have been appointed by the promoters) be interested in seeking an outside opinion regarding the promoters' intentions?

Some suggest that the IDs should meet independent of the promoters. However, the low knowledge base of most IDs about the corporate world and laws/regulations would make such meetings unproductive.

It has also been suggested that the audit committee should independently meet with the auditors in order to extract the truth. Other untenable suggestions include—focus on quality not quantity of IDs; include IDs from diverse backgrounds; provide legal immunity to IDs. All these would not help in any way to make the IDs truly independent.

The natural conflict between promoters (whose primary motivation would be to enrich themselves) and the IDs who are supposed to prevent this from happening is at core of the problem.

The concept of independent directors is not viable in the Indian context at this point of time. IDs may make some sense in the US for

example, where companies are widely held and where the rampant undue enrichment of the non-promoter CEOs has to be curtailed. In India, most companies are family-run (nearly 98%); the stranglehold of the promoters on their companies is near-complete. Most listed companies are actually run like proprietary firms. Expecting such families to induct true IDs is merely wishful thinking.

The situation becomes worse when the promoters hold 90% of the stock, as has been the case with most of the new listings in the past 6 years. Small public stakes cannot put any effective pressures on the promoters, and they look at the institution of IDs with even more contempt.

Then there is the mutualisation conflict which is dominant at the corporate level—the positions of owner, chairman, and CEO are vested with the same individual. This then decimates the role of IDs.

Given the ecosystem, most companies have to fight to set up their enterprises, for survival and for achieving growth in as short a time as possible, and their troubles are further compounded by the compulsions of quarterly results. And hence they would arguably use all means to achieve their objectives rather than wait for the big benefit in the longer term that may accrue with good practices.

The mandatory requirement of ID therefore deserves to be scrapped. IDs will always be appointed by the promoters; corporations would neither accept outsiders nor should outsiders be imposed upon them. So the intended benefits of the institution of IDs would always remain a mirage. Neither principle-based nor rule-based regulations will work. Let companies induct IDs if they find it necessary and let investors see value in such IDs. This way, only quality IDs will get appointed, and investors will demand and respect high quality IDs and value such companies differently.

Our conclusion therefore is that the institution of IDs under the present dispensation is not an effective enabler of good CG. It should be the job of the regulators to detect and punish non-compliance and unacceptable corporate behaviour, not the job of the IDs. A bold alternative approach needs to be adopted to achieve the regulatory objectives of higher standards

of governance in corporations. Some suggested initiatives are enumerated below.

The first step would be a comprehensive review of all the regulations, making these meaningful, simpler, and free of loopholes. It is better not to have laws than to have ones which are opaque or which cannot be enforced.

It would be necessary to mandate better corporate disclosures. The requirements on disclosure need to be reviewed with a focus on quality and not quantity, and also to make these meaningful for the investors. Also, severe punishment for non-disclosures and wrong disclosures should be mandated.

Making auditors more accountable is another step. No concessions should be allowed to the auditors; it should be their responsibility to ensure that they have reviewed all the papers themselves and have not depended upon the management's confirmations. Moreover, auditors should not be appointed by the promoters (who also are in the voting majority at the AGMs). The auditors' job is to prepare financial statements not for the promoters but for the public shareholders. Auditors for listed companies should be selected (based upon objective criteria) from a panel created by MCA/SEBI; these auditors can then be subjected to greater regulations and oversight. The audit fee should be paid from IEPF/IPF or from a new transaction fee/listing fee.

Errant auditors should be punished severely, and their certificate of practice should be revoked. Also, all audit firms who resign from their clients should be required to submit a detailed report to the regulators explaining in detail the reasons for their resignation.

It would make sense to do away with quarterly results, since this requirement has increased the pressure on the promoters to perform on a quarter on quarter basis. As a result, this requirement has actually become a big deterrent to CG.

The most important move would be to enforce compliance of regulations. Instead of depending upon the IDs, the regulatory agencies

should strengthen their surveillance and enforcement functions (including an Early Warning System) to ensure compliance of all laws and regulations. Alongside, there is a need to develop a system for swift investigation and also swift and adequate punishment to the offenders, which will also act as a deterrent. What is urgently required is compliance, and punishment for non-compliance.

However, we recognise that to scrapping the very institution of ID would be a controversial move, as it has been ostensibly introduced for the protection of minority shareholders. It therefore appears that IDs would stay as a mandatory institution despite its ineffectiveness. The way forward is to strengthen the entire system surrounding the appointment and functioning of IDs.

The caveat, however, is that none of this will in any way significantly improve the institution of IDs or bring about better CG. It may be reiterated that there cannot be real IDs if they are going to be appointed by the owners. Moreover, if quality cannot be mandated, corporates would continue to comply only in letter and would keep finding new loopholes when the present ones are plugged.

Nevertheless, some progress can be made by implementing the following suggestions.

The appointment process of IDs needs to be changed. A Nomination Committee, comprising only of IDs (like in the US), should be made compulsory. The appointment of IDs should be based on merit and other objective criteria. Only persons who can clearly demonstrate that they have enough time should be considered.

Public disclosures should be made on how an ID was found and why is he/she being nominated, along with all his/her past and present relationships of any kind with the company, promoters, major shareholders, and management. The profile of the ID along with all present significant commitments and also the proposed remuneration should be put on the websites of the company and the stock exchanges for public comments for 21 days.

All new IDs should be required to pass a Directors' Knowledge Test before appointment. There should be a professional institution of directors. Membership should be obtained by passing necessary examinations after a course of instruction at or by reputed/selected business schools/academic centres. The board appointments should be limited to such Certified Directors. All existing IDs could be given a 6-month timeframe to pass the same test. The test should be very extensive and assess the person's knowledge of finance, Companies Act, SEBI Act/regulations and the like.

No person, including retired people, should be allowed to hold ID positions in more than 3 listed companies. Promoters of listed companies or persons who are fulltime employees anywhere should not be permitted to hold even one ID position. In addition, no person should be allowed to be a member of more than one audit committee of listed companies.

For every agenda item at the board meeting, the management should attach a "Negative Impact Analysis on Minority Shareholders", proactively stating whether the agenda item has any impact on the rights/interests of the minority shareholders. The IDs should discuss this impact analysis and offer their comments, which should be recorded in writing.

Full details of every single proposed related party transaction should be provided to the IDs, and their approval should be obtained. Similarly, full details of all transactions with any subsidiary company should be disclosed to and approved of by the IDs.

Demutualisation needs to be mandated. The functions of the owner, chairman, and CEO should ideally vest in three different persons, with the chairman being compulsorily an ID, who is appointed in the same manner as described above for an ordinary ID.

The time limit for finding a replacement for an outgoing ID should be set at 60 days at the maximum, and the responsibility for the same should rest with the Nomination Committee.

The uniform 50% requirement needs to be reconsidered. The number of IDs could be related to the percentage of non-promoter holding, as against

50% across all cases. The higher the promoter holding, the higher should be the percentage of IDs.

A new paradigm on board composition is required. We recommend that one-third of the board should comprise promoter-directors, another one-third should comprise value directors appointed by the management (who would not be deemed as IDs), and the remaining one-third should be the real IDs, who are qualified, and have experience in corporate affairs, and who are selected from a pool created by the regulator and who are then subsequently trained and pass the Directors' Knowledge Test.

ID requirement for PSUs should be dropped, or the process of appointment of IDs should be changed. PSUs already enjoy many exemptions including on minimum public float. They should be exempted from this requirement also; more so because PSUs in any case are subject to additional scrutiny/audit like from CVC, CAG, and the Parliament. Alternatively, the power to induct IDs should be transferred to the Chairmen and the boards of the respective PSUs, which will then allow them to get the IDs both before their IPOs and also find replacements, whenever required, post-listing.

Additionally, the term *relatives* needs to be expanded, to include several levels of relatives, and include people from the mother's side as well as from the spouse's side. If IDs in a company are related to each other, only one of them should be deemed as an ID.

Persons who are nominated under a lenders' or a shareholders' agreement should not be treated as IDs. Moreover, the minimum age for IDs should be 35 years, at the least, and the maximum age should be capped at 65 years.

Each company should be required to have a board-level compliance committee comprising both promoters and IDs whose sole mandate is to ensure compliance of all laws and regulations. Members of this committee should be individually liable for negligence or connivance.

All IDs should provide a detailed certificate of independence at the time of appointment, and annually thereafter. This certificate should cover

any and all past and present relationships the ID has/had with the promoters, management, company, and other directors. This certificate should be put up on the website of the company and of the stock exchanges.

A cap on remuneration may not be desirable, and should be decided on a case by case basis. However, the remuneration earned by an ID from any single company should not exceed 15% of his total annual income, in order to reduce his dependence. Moreover, ESOPs and commissions should not be granted to IDs.

Clause 49 presently requires all domestic subsidiary companies of a listed company to also have IDs. This requirement should be extended to foreign unlisted subsidiaries of the Indian listed companies.

Many countries in the world recognise the institution of lobbyists. Several value directors in India are in reality playing that role. It may be worthwhile to recognise this institution which would then allow many people to become professional lobbyists without joining the boards of companies to perform that role.

There is a need to ensure stringent compliance of Clause 49. Non-compliance with regard to Clause 49 needs to be punished. The only effective punishment would be a significant penalty on the promoters/managements in their personal capacities, and in extreme cases, throwing out the promoters/management and bringing in new management. This should also be applied to PSU companies, where the Government is the promoter.

Mandating exit interviews for IDs who resign would enable the regulator to find a way to convert these IDs into whistleblowers of sorts, and identify the ills affecting the companies from which they have resigned.

Institutions would have to shed their passive, inactive roles and take proactive decisions on company agendas. They should also be required to publicly disclose their voting on each resolution annually. Retail investors would gradually give their monies to such institutional investors who are protecting their interests. Greater institutional investors' involvement would also keep the IDs on their toes. Institutional investors should also play an active role in the appointment of IDs.

An effective whistleblower policy needs to be mandated for each listed company. Anonymous complaints should also be entertained. Only an ID should be appointed in a company to receive such complaints/ information.

We also propose that all CG awards should be banned.

6. Conclusion

As long as IDs are appointed by the promoters, independence shall remain a myth. Moreover, quality cannot be mandated and corporates would continue to comply only in letter and would keep finding new loopholes when the present ones are plugged. On the other hand, nominating IDs by an outside body would be counter-productive.

The biggest paradox is that an ID is required to be independent of the very promoter who has appointed him and whose wrongdoings he is supposed to prevent. And yet, the regulations expect the institution of IDs to ensure good CG.

Ultimately, CG is not a matter of regulation. Governance has to be driven by the management and there is no substitute for that. Good behaviour will be valued and respected by the market. Expecting regulations to infuse morality into people is an utopian idea, given the corporate ownership and control scenario in the country.

Notes

[1] Corporates initially protested about the non-availability of professionals qualified to become IDs. In response to this, primedirectors.com was created (by the author) which is a free service where professionals can register themselves; listed companies are provided access to the database so that they can select from among the over 19,000 profiles available. However, the response from the corporates has been very poor—only about 300 people have been sourced from this particular website at the time of writing.

[2] Following various representations, the minimum age requirement was fixed as 21. As of 31 December, 2009, there were as many as 248 IDs below the age of 35, with 7 being even younger than 25.

[3] This number was 389 as on 31December, 2006; the public disclosure of multiple directorships through directorsdatabase.com led to many individuals reducing their directorships.

[4] www.directorsdatabase.com profiles the directors on the boards of companies. As of 31 December, 2009, 2,461 out of a total of 2,930 companies (84%) listed at BSE had filed information related to their directors.

15

Strengthening the Institution of Independent Directors

Subrata Sarkar*

1. Introduction

Corporate governance reforms in developed and developing countries have focused on making corporate boards more effective in ameliorating agency problems between shareholders and managers in publicly held corporations. An important element of this reform has been to make corporate boards more outsider-oriented, with a mandate specifying the ratio to be maintained between the number of independent directors and executive directors comprising the board. The rationale behind this move has been the agency theoretic view that independent directors—due to their presumed independence relative to insiders on boards—can be more effective in curbing managerial opportunism as these directors have incentives to promote the interests of shareholders in order to protect their reputational capital and to prevent being sued by shareholders (Bhagat et al., 1987; Fama, 1980).

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A typical board of modern corporations consists of inside or executive directors who are full time employees of the company and are involved in its day to day operations and outside or non-executive directors who do not have any executive responsibilities and play a mostly advisory role. The outside directors are generally further classified into affiliated directors (or grey directors) who are former company officers, relatives of company officers, or those who have existing business relationships with the company such as investments bankers and lawyers; and non-affiliated directors who are outside directors with no such affiliation. Non-affiliated outside directors, commonly referred to as non executive independent directors or simply as independent directors, are the ones who are expected to perform the monitoring role and are widely regarded as the fiduciaries of the shareholders' interest.

Since the board consists of both management or executive directors as well as non-executive directors, this raises the obvious question: "If the board is responsible for formulating and implementing the business strategy then how credible is it to expect that it will be forthright in ensuring the accountability of the very actions that it has taken by itself?" In the early days when modern corporations were being formed, the principle of "accountability through disclosure" was the primary method of holding executives responsible for their actions. Outside directors were expected to provide expert vision and fresh thinking to foster the growth of the company rather than to monitor executive actions. However, with the increase in size and complexity of operations of modern organisations the effectiveness of the principle of accountability through disclosure has been severely attenuated. While regulations in most countries now require a large amount of information disclosures, and have prescribed standards and codes for financial reporting, executives still retain a large degree of freedom in financial reporting due to the existence of ambiguities and alternatives in financial reporting. Indeed instances of creative accounting practices and earnings management are widely documented in academic studies. Under these circumstances, regulations in many countries have started emphasising the monitoring role of the independent directors as the

principle way of ensuring the accountability of executives for their actions. This move has been strengthened by the collapse of some large corporations in the UK and the US that were believed to have had very efficient boards and highly celebrated CEOs, and by reported instances of self dealings by insiders particularly with respect to executive compensation. Thus the Combined Code of the Financial Reporting Council in the UK, the Securities and Exchange Commission's regulations in the US, and the stock exchange listing agreements' Clause 49 in India (as mandated by the Securities and Exchange Board of India), all emphasised both the need for and the role of the independent directors in ensuring high standards of corporate board governance.

The theoretical arguments behind the composition and functioning of the board of directors have their origin in the works of Fama and Jensen (1983a, 1983b) who distinguished between the concepts of decision management and decision control. Decision management refers to the initiation and implementation of decisions, while decision control refers to the ratification and monitoring of decisions. Agency costs arising from separation of ownership and control which are characteristic of modern day corporations are minimised when decision management and decision control rests with two independent groups—decision management resting with the executive directors who have the necessary skills and expertise to operate the firm in the most profitable way, and the decision control rests on the residual claimants, or the representatives of the residual claimants, who bear the cost of managerial discretion. Thus the composition of the board of directors serves a vital role in ensuring that managerial discretion is exercised in the best interests of the shareholders.

2. The need for independent boards in Asian corporations

The need to have an independent board is heightened in the case of Asian economies including India, where family owned corporations belonging to business groups dominate the corporate landscape, and where family members with substantial ownership and control rights occupy managerial positions with the objective of controlling the firm. When

ownership and control are concentrated in the same hands, the nature of the agency problem changes vis-à-vis diffused ownership structures, from shareholder manager conflicts (Type I or "vertical" agency problems) to conflicts between two categories of principals—the controlling inside shareholders, and minority outside shareholders (Type II or "horizontal" agency problems). While controlling shareholders have a strong incentive to monitor and thus limit Type I agency problems, they also have both the incentive and the opportunity to extract and optimise private benefits for themselves at the expense of minority shareholders (Morck et al., 2005). Gaining effective control of a corporation enables the controlling owner to determine not just how the company is run, but also how profits are being shared among the shareholders (Claessens & Fan, 2002). Although minority shareholders are entitled to the cash flow rights corresponding to their share of equity ownership, they face the uncertainty that an entrenched controlling owner may opportunistically deprive them of their rightful share of profits through various means.

Several Type II agency costs are associated with family and other dominant ownership *per se*. Agency costs can arise on account of the family owning substantial stocks in family enterprises, by virtue of which it gets directly involved in the operational management in the capacity of CEO or as members of senior management. This gives them large discretionary power over a firm's decisions, which in turn can facilitate expropriation of minority investors. Bautista (2002) for instance observes that owing to the dominance of family members in decision making and the non-transparency in functioning, minority shareholders are often kept in the dark regarding the actual state of the corporation. Further, expropriation of minority shareholders can occur through controlling owners acquiring control rights in excess of ownership rights by using pyramidal structures in the organization of several group firms. When controlling shareholders are widely held corporations instead of families, agency problems with respect to minority shareholders can stem from corporations making deals between a parent firm and a subsidiary through related-party transactions that may not benefit the subsidiary's minority shareholders.

The empirical evidence from Asia and Europe with regard to the presence of Type II agency costs in the context of corporations with concentrated ownership and control is substantial. For instance, cross-country analyses of business group firms in East Asian and Western European economies, as well as emerging markets find a negative association between firm value and the wedge between control and cash flow rights (Claessens et al., 2002; Faccio et al. 2001; Lins, 2003). Country-specific studies also indicate similar results. The study by Joh (2003) of Korean business groups finds that firm performance is negatively related to the divergence between control and cash flow rights suggesting the presence of expropriation; Bertrand et al. (2002) find evidence of tunnelling in Indian business groups. The accounting literature on earnings management and earning quality has also produced evidence that a greater divergence between control and cash flow rights leads to higher earnings manipulation by the controlling shareholders. Based on a sample of Korean firms Kim and Yi (2005) conclude that a greater divergence between ownership and control results in higher opportunistic earnings management because controlling shareholders want to hide their private benefits of control. Further firms affiliated to business groups are engaged in higher earnings management compared to non-affiliated firms. Studies with respect to Chinese listed companies find that earnings management in China is driven by related-party transactions (Jian & Wong, 2003), and is induced by the controlling shareholders' incentives to tunnel. Liu and Lu (2007) find that firms with better governance (represented by a composite corporate governance index) engage in lower earnings management in China.

3. Promoter dominance in Indian companies

Promoter dominance in corporate ownership

The Indian corporate sector is characterised by firms with concentrated ownership and control akin to those dominating most developing and emerging economies. Domestic private sector firms are either affiliated to business groups or are non-affiliated standalone firms. Both standalone

and group-affiliated firms are largely family firms with considerable equity holdings by family members as well as family involvement in the management of the companies. Since the early days of industrialisation, corporate sector activities in India have been dominated by business groups. The dominance of group affiliates is evident from the fact that the percentage of group affiliates in the top 50 corporate sector firms ranked by assets has remained around 80% over the years. In 2006, eighteen of the top 20 listed firms ranked by market capitalisation belonged to business groups.

Both group affiliates and standalones can be either widely held or have concentrated ownership. However, an examination of the ownership structure of a large sample of listed firms reveals that a large majority of firms in India (irrespective of their ownership affiliation) are characterised by concentrated ownership and control structures and widely-held firms (where no shareholder controls 20% votes)[1] are an exception rather than the rule. As of 2006, the percentage of such firms in a sample of 1965 listed Indian private sector non-financial and non-financial firms (accounting for more than 80% of the total market capitalisation) is only 5.5%. As is evident from Table 1, which presents roughly comparable estimates of widely-held firms across different countries, this percentage is substantially lower than the estimates derived for countries dominated by widely-held firms, such as the UK, the US and Japan, and is also relatively lower than the percentage in countries in Europe and East Asia, which are typically dominated by concentrated ownership structures. The estimates for widely held companies in India are however comparable to Hong Kong, Indonesia, Singapore, and Thailand (Table 1). If one considers the percentage of widely held companies in the largest 20 corporates across countries, India stands out as an exception—none of the top 20 listed companies, ranked either in terms of market capitalisation or asset size, are widely held. In fact, the largest blockholders in these companies, with an average market capitalisation of Rs. 376310 million (approximately $8362 million), are families with an average holding of around 48%, the minimum and maximum holdings across the companies being 22% and 85%, respectively.

Table 1: Control of publicly traded companies in select countries

Countries	Percentage of listed firms widely held[1] (i)	Percentage of top 20 firms widely held[2] (ii)
India	7.2	10
US and Europe		
US	Not available	80
UK	63.1	90
Germany	10.4	50
Italy	13.0	20
East Asia		
Japan	79.8	90
Hong Kong	7.0	5.0
Indonesia	5.1	15.0
Korea	43.2	65.0
Malaysia	10.3	30.0
Philippines	19.2	40.0
Singapore	5.4	20.0
Taiwan	26.2	45.0
Thailand	6.6	10.0

Source: The data presented in column (i) for select European countries was sourced from the study by Faccio and Lang (2002) of 5232 listed firms across 13 European countries. The data in (i) for East Asian corporations was sourced from a study by Claessens et al. (2000) of 2980 publicly traded corporations for the year 1996. The data in column (i) presented for India was computed by the author based on a sample of 1965 publicly traded Indian companies for the year 2006 based on data obtained from CMIE Prowess database. The data in column (ii) for US and Europe were sourced from La Porta et al. (1999). The sources of the remaining data are the same as in column (i).

The pervasiveness of family control among Indian corporates is further evident from Table 2. Unlike most other countries in East Asia, family control in India is common both among the large companies (top 20) as well as in the smaller companies (bottom 50), and is highest when compared to East Asian countries. From the estimates in Table 1 and Table 2, it can be inferred that Type 1 agency problems would be less important in India, while given the complex structure of family owned business groups, Type II agency problems are likely to exist in a large measure.

Table 2: Family ownership of listed firms in select countries

Countries	Percentage of listed firms held by family by size		
	Largest 20 (i)	Smallest 50 (ii)	All (iii)
India	85.0	94.0	88.0
East Asia			
Japan	5.0	57.0	9.7
Hong Kong	72.5	57.0	66.7
Indonesia	60.0	93.0	17.5
Korea	20.0	97.0	48.4
Malaysia	35.0	84.0	67.2
Philippines	40.0	45.0	44.6
Singapore	32.5	67.0	55.4
Taiwan	15.0	80.0	48.2
Thailand	57.5	76.7	61.6

Source: The data presented for East Asia was sourced from a study by Claessens et al. (2000) of 2980 publicly traded corporations for the year 1996. The data for India was computed by the author based on a sample of 1965 publicly traded Indian companies for the year 2006 based on data obtained from CMIE Prowess database.

Promoter influence on corporate boards

This extensive dominance of promoters in corporate ownership in India is mirrored in their dominance on corporate boards. Table 3 presents the trends in board composition and promoter dominance for the period 2003–2008 in Indian companies. A typical board in India comprises 30% executive or inside directors and 70% non-executive or outside directors. While the presence of such a large percentage of outside directors might suggest outsider dominance, about 20% of these outside directors are in reality affiliated directors, many of whom are promoters or relatives who occupy board seats as non-executive members. The figures in Table 3 show that the composition of the typical board has remained quite stable over the years.

In 2003 two out of every five companies in India typically had a promoter present on the board. More importantly, the presence of promoters on company boards has increased significantly over the years with a noticeable jump in 2005—approximately around the time when stricter governance regulations became applicable to virtually all listed companies. By 2008, every three out of five Indian companies had a

promoter on board. The disaggregated data shows that while promoters have increasingly taken up positions both as inside and outside directors, the increase has been much more significant for positions as inside directors. Thus while the proportion of companies having promoters as outside directors increased from 26% in 2003 to 33% in 2008, the proportion of companies with promoters as inside directors increased from 32% in 2003 to 47% in 2008, suggesting an escalating promoter role in executive management.

Table 3: Promoter influence in company boards

	2003	2004	2005	2006	2007	2008	All Years
Board Size	9.80	9.56	9.01	9.11	9.20	9.41	9.34
Board composition							
Percentage of Inside Directors	28.61	29.31	30.86	29.43	28.14	28.23	28.99
Percentage of Grey Directors	17.87	18.40	18.53	21.54	21.91	19.90	19.93
Percentage of Independent Directors	53.52	52.29	50.61	49.03	49.95	51.87	51.08
Proportion of companies having							
A Promoter Director	0.40	0.45	0.54	0.63	0.56	0.59	0.54
A Promoter as an Executive Director	0.32	0.37	0.41	0.50	0.44	0.47	0.43
A Promoter as a Non-Executive Director	0.26	0.28	0.37	0.41	0.32	0.33	0.33
In companies with a promoter director, percentages of board seats held by							
Promoter Directors	30.86	31.26	32.61	30.21	28.68	27.98	29.91
Promoter Executive Directors	16.79	17.10	16.71	16.94	16.30	16.38	16.66
Promoter Executive Directors	14.06	14.16	15.90	13.27	12.38	11.60	13.25
In companies with a promoter director, proportion of companies where							
Promoter is Chairman or Managing Director	0.81	0.82	0.92	0.94	0.94	0.95	0.91
Promoter is Chairman	0.72	0.73	0.85	0.87	0.85	0.86	0.83
Promoter Share (%)	54.45	54.69	53.22	52.50	52.63	53.17	53.35

Source: Author's calculations based on a sample of top 500 listed companies in India. The data was compiled from the Corporate Governance Reports contained in the Annual Reports of Companies.

When promoters are present as directors in a company, they exert a significant influence on the board. Table 3 shows that in 2003 promoters occupied three out of every ten seats in companies where they were present as directors. This proportion has remained essentially the same over the years with a slight decrease in 2007 and 2008. The board seats were almost equally split between inside and outside positions in 2003–2005 but showed a relative shift towards inside positions since 2006. In 2008, in those companies where promoters were present, they occupied 16% of these seats as inside directors compared to 12% as outside directors. More importantly, Table 3 shows that when promoters are present in the board, they occupy key board positions. In 2003, when promoters were present on the board, they occupied the position of either the chairman or the managing director in 80% of the companies. This percentage increased very significantly over the next five years and by 2008, except for 5% of the companies, promoters occupied the position of chairman or managing director in all the companies where they were present on corporate board. Finally, as the last row of Table 3 indicates, promoter ownership has been well over 50% giving the promoter absolute control over these companies.

The above analysis suggests that Indian companies (at least the large ones) are virtually controlled by promoters in terms of both ownership as well managerial discretion. While this might reduce Type I agency costs, the possibility of expropriation of minority shareholders in this setting is high. One way of exerting corporate governance is to publicise the ownership structure of these firms, and then let investors take their own decisions based on their informed judgment. If agency costs are really serious—with increasing Type II agency costs outweighing the benefits of concentrated ownership—then stock discounts will automatically endogenise the costs of family ownership and force companies to move towards better corporate governance practices. Moreover shareholders can initiate litigation in a court of law if there are fraudulent practices. This seems to be the approach in the New York Stock Exchange (NYSE) Regulations which do not require the adoption of the NYSE codes related

to board independence and independence of nomination and compensation committees[2] with respect to controlled companies. However in emerging economies where investor education is low and legal protection is weak, there is merit in proactive steps being taken by the regulator to safeguard the interest of the minority shareholders. If one accepts this view then designing appropriate mechanisms for good governance is a must.

In this scheme of things, the board of directors, and especially the institution of independent directors, becomes an important regulatory mechanism for the protection of minority shareholders. It could be argued that there are many other internal and external mechanisms like the market for corporate control, the managerial labour market, shareholder activism, debt bonding, performance contingent managerial compensation contracts, and so on which could act as alternative governance mechanisms. However, in each of these cases, the crucial input is information disclosure. When control is concentrated both in terms of ownership as well as management discretion, the production of information that gives a full and fair view of the operations of the company is paramount for governance. Given the proliferation of listed companies worldwide and especially in the growing economies in East Asia and certainly in India, oversight of the financial reporting process by the regulator becomes infeasible. In such cases, the oversight of information production must rest with a body that is internal to the company and that is independent of the management. The institution of independent directors offers this internal mechanism. It is therefore not surprising to find that regulations in many countries, whether developed or emerging, are increasingly moving towards having independent boards, and are requiring that audit committees, nomination committees, and compensation committees be composed solely of independent directors (see for example the amended NYSE Regulations, effective November 2009). The excessive managerial remuneration that has been identified as one of the most important reasons behind the financial crisis of 2008 has also led to an increasing demand for compensation committees to be staffed by independent directors to avoid self dealing by inside directors. While there could be considerable debate over the exact procedures involved in

designing an independent board and independent audit committees and compensation committees, the very idea of strengthening the concept of independence probably cannot be questioned especially in the context of East Asian corporations and India.

4. The move towards independent boards across the world

Though an alternative view questions the efficacy of independent directors in mitigating managerial opportunism and serving shareholder interests (see Fink, 2006; Mace 1986; Morck, 2004, among others for a review), a survey of corporate governance reform initiatives across a cross-section of countries irrespective of their underlying institutional contexts reveals that these initiatives have been predominantly influenced by the agency theoretic view that independent boards are good for corporate governance and for protecting shareholder and other stakeholder interests. The concept of an independent director became part of the corporate governance lexicon in the 1970s, and the move towards board independence that originated in the US as a good governance exhortation soon acquired the status of a legal requirement (Gordon, 2007). Between 1994 and 2000, at least 18 countries came out with recommendations or stipulations on the minimum requirements (either in absolute terms or as a proportion of total board strength) for outside directors on company boards (Dahya & McConnell, 2003).

With corporate boards gradually being expected to perform more of a monitoring role rather than merely an advisory role (often due to governance failures), the shift towards having more outsiders on the board, and in particular having more independent directors, has become increasingly pronounced, legally binding, and more stringent with time. As estimated by Gordon (2007), between 1950 and 2005, the proportion of independent directors on company boards in the US steadily increased from around 20% in 1950 to around 75% in 2005. Regulations in many developed countries now require or recommend a majority or substantial presence of independent directors on corporate boards. For example, the NYSE Listing standards (Section 303A.01 of NYSE Listed Companies

Manual)[3] now require all public companies to consist of a majority of independent directors, while the UK Combined Code on Corporate Governance, and the Australian Stock Exchange recommend a majority of independent directors on corporate boards.

Emerging economies too seem to be moving towards the constitution of more independent boards. The IBGC Guidelines of Code of Best practice in Brazil recommends that corporate boards have a majority of independent directors, while the HKEx Main Board Listing Rules in Hong Kong requires boards have a minimum of three non-executive independent directors, and the Code of Corporate Governance in Singapore recommends that at least one-third of the board should comprise independent directors. Following the general trend worldwide, the current Clause 49 regulations in India require at least one-third of the board to consist of independent directors if the company has a non-executive chairman, and at least half of the board to consist of independent directors if the company has an executive chairman or the chairman is related to the promoter.

One notable difference between developed countries and emerging economies is that the regulatory requirement for the percentage of independent directors in general seems to be low for emerging economies. This is quite surprising because corporations from emerging economies which represent higher insider control would be more in need of independent oversight. One potential explanation for the lower requirement of independent directors could be that the evolution of corporations and the dominance of family business in these economies make the process of change more gradual.

What is interesting however, is that while regulatory requirements both in developed and emerging economies require a majority of independent directors on company boards (for example the NYSE regulation), the percentage of independent directors actually employed by companies far exceeds the regulatory requirements. Thus in the US, a typical corporate board comprises 75% independent directors (the regulatory requirement is for a majority of independent directors on the board), while a typical board in Australia and Canada has slightly more than 70% independent directors.

While the Code of Corporate Governance in Singapore recommends at least one-third of the board to consist of independent directors, a typical board contains 50% independent directors. The board composition of these countries seem to suggest that companies perceive independent boards as adding value to a company, and leading to favourable assessment by outside investors with corresponding benefits of lower cost of capital and ultimately higher value of the company.

5. Does board independence matter in governance?

Given the move towards independent boards across the world, we next look at what the empirical literature has to say on the effect of board independence on corporate governance in general, and firm performance in particular. Here, the evidence can be divided into two parts—the first analyzing the performance of independent boards in accomplishing discrete tasks (such as hiring and firing of CEOs, response to takeovers, determining CEO compensation, and the probability of litigation), and the second analyzing the effect of independent boards on firm value in the long run.

With respect to accomplishing discrete tasks, the empirical literature suggests that boards with more independent directors tend to behave differently compared to boards with a lower representation of independent directors. One of the primary tasks of the board is to monitor the CEO and replace him in the event of serious underperformance. Weisbach (1988) finds that boards with more independent directors are more likely to replace a CEO following poor performance compared to boards with a lower measure of independence. Scott and Kleidon (1994) who look at firm performance pre and post CEO replacement find that firms with majority-outside boards who fire their CEO have worse pre-replacement performance compared to other firms. With respect to takeovers, Cotter et al. (1997) find that tender offer targets with majority-independent boards realise 20% higher stock price returns compared to targets without majority-independent boards. Byrd and Hickman (1992) report that tender offer bidders with non majority-independent boards tend to have

significant negative returns while bidders with majority independent boards do not suffer any such loss. With respect to securities litigation, Helland and Sykuta (2005)—using data from 21500 private securities litigations as well as Securities and Exchange Commission (SEC) filings in Federal Court between 1988 and 2000—find that firms with boards having a higher proportion of outside directors have a lower probability of being sued, and that outside directors do a better job of monitoring management.

While the findings suggest that more independent boards behave differently from less independent boards, they do not tell us if long term firm performance improves say after the firing of the CEO. For every CEO who is fired, a new one has to be employed and it is not clear from these studies if the board is qualified enough to do this job (Bhagat & Black, 1998). While this is indeed an important question, this critique essentially mixes two issues—replacing a poorly performing CEO, and hiring a new one. A new CEO can be hired only if the currently poor performing one is fired, and therefore the positive effect of an independent board in accomplishing the first objective is a signal of the competence of the board. Hiring decisions are not the primary responsibility of the independent directors, and independent directors are not hired for their specialised skills in CEO recruitment. In any case, the independent directors can take the help of external hiring experts to assist them in hiring a new CEO.

The evidence from developed countries and those from emerging economies offer a contrasting picture with regard to whether having independent boards correlates with the long term value of the firm. In developed countries with a long tradition of independent boards like the US, the correlation is admittedly weak, raising doubts as to whether the "outside director mania" across countries and the presumption that the outside directors matter "rests more on faith than on evidence" (Dahya & McConnell, 2003). Baysinger and Butler (1985) and Hermalin and Weisbach (1991) report no significant correlation between board composition and various measures of corporate performance. In a comprehensive study of 957 large US public corporations over the period 1983–1995. Bhagat

and Black (2002) found no consistent evidence that the proportion of independent directors affects firms' performance based on a number of stock price and accounting indicators. Their study showed that while the proportion of independent directors is associated with slower past growth and stock price performance (suggesting that poorly performing firms might hire more independent directors), this association disappeared for future performance. Some studies suggest that firms with more independent directors might actually perform worse, with the proportion of independent directors correlating negatively with Tobin's Q (Agrawal & Knober, 1997; Yermack, 1996), though these extreme results are not robust when using alternative measures of performance; besides some of these studies use outside directors as opposed to independent directors to study the effect of board composition.

While the evidence on the correlation between board independence and firm value from developed countries is weak, the evidence from the growing empirical work on emerging economies tends to suggest that higher board independence correlate with higher firm value (see for instance Peng, 2004 in the context of China; Yeh & Woidtke, 2005 in the context of Taiwan; Black et al., 2006 in the context of South Korea; Sarkar & Sarkar, 2009 in the context of India). The study by Peng (2004) provides evidence of a positive effect of independent directors on firm performance for a sample of listed Chinese firms when performance is measured in terms of sales growth, but of no impact if performance is measured as return on equity. Results similar in spirit to the Chinese study are reported with respect to a sample of Taiwanese firms (Yeh & Woidtke, 2005)—companies with boards dominated by members affiliated with the controlling family do worse than companies where the board is dominated by non-affiliated members. Black et al., (2006) in their analysis of listed companies in South Korea find a strong correlation between board composition and firm value, with companies consisting of a majority of outside directors showing significantly higher value. An empirical analysis of the effect of boards dominated by independent directors in large Indian companies (Sarkar & Sarkar, 2009) finds firm value to be positively correlated with

the expertise of the independent directors, proxied by the extent of their multiple directorships. The findings from these studies tend to suggest that an independent board can act as a potential countervailing mechanism to diminish the influence of controlling shareholders on corporate boards, and can be successful in ensuring that managerial discretion is exercised in the best interests of all the shareholders.

Additional evidence related to the positive effects of independent boards and independent audit committees which are created from a subset of the directors on the board, comes from the extant accounting literature that looks at the effect of board composition on earnings management and earnings quality. Using a sample of 92 US firms under SEC investigation for manipulating earnings, Dechow et al. (1996) find that firms with a higher proportion of independent directors, smaller boards, and with an audit committee have lower earnings manipulation. Studies with respect to UK largely mirror these findings. Peasnell et al. (2000) in their empirical analysis of the effect of the recommendations of the Cadbury Committee Report on a large sample of UK firms found that non-executive directors had become more efficient in constraining earnings management practices in firms adopting the Committee's recommendations. Peasnell et al. (2005) also provide evidence that independent directors reduce earnings manipulation, and that their effectiveness in doing so increases when the board appoints an audit committee.

Though studies on the effect of board or audit committee independence on earnings management with respect to emerging economies are limited, the few that exist find that even if board independence per se does not reduce earnings management, the expertise and diligence of the independent directors do have a significantly positive effect. For example, Sarkar et al. (2008) in their study of 500 large companies in India for the years 2003 and 2004 find that the quality of board as captured in terms of the diligence of the independent directors (manifested in their ability to devote time to company affairs) has a strong beneficial effect on reducing earnings management, while CEO duality and the presence of controlling shareholders on boards seem to increase earnings management.

6. What explains the weak relation between board independence and firm value?

While the evidence on the correlation between board independence and firm performance tends to suggest that independent boards seem to do better with respect to discrete tasks and other performance measures like earnings management and earnings quality, their effect on firm value from developed and emerging economies offer contrasting results. In emerging economies, the evidence mostly suggests that an independent board tends to neutralise the effect of controlling shareholders on the board; however evidence of its strong direct effect on long term firm value remains somewhat elusive. The uncertain relationship between board independence and governance seems to run counter to the unambiguous policy position taken across countries irrespective of their governance systems, that board independence is critical for mitigating agency problems in public corporations. How does one resolve this puzzle of the gap between policy prescription and ground realities? What then is the future of board independence?

There are two reasons for these differences. In developed countries alternative control structures like CEO compensation, takeover markets, ownership patterns, etc. have adjusted optimally to the corporate governance needs of different firms, and so it is difficult to find any relation between firm performance and a specific control mechanism. Secondly, firms in developed countries (especially in the US on which most of the evidence is based and which has a long history of shareholder activism) irrespective of existing regulations, may have voluntarily chosen to have a few outsiders on boards with little variance in board composition over time. This would again imply that the effect of changes in board composition on corporate performance may be difficult to detect. This conclusion seems consistent with the fact that in the US, corporate boards seem to contain independent directors far in excess of what is required under regulations. Until the current changes in December 2003 (most of the studies on board independence in the US predate this), US regulations required company boards to have a minimum of three independent directors. Yet a typical corporate board of 11 members contained six independent directors (Bhagat & Black, 2002).

However, while this equilibrium argument can explain the lack of any systematic relation between board independence and firm value in developed countries, it is inadequate to explain the lack of any strong evidence with respect to emerging economies which are still evolving in terms of their governance structures. An explanation for this might come from the findings of experiments in social psychology which suggest that behavioural issues in the presence of an authoritative figure may often hinder the exercise of independent judgment; this might explain the lack of a strong relationship between firm value and independence of corporate boards. These experiments highlight how simple elements of human behaviour (like loyalty) impede the independent decision making process of an individual. Referring to the famous Milgram experiment (1963, 1974),[4] Morck (2004) argues that in the absence of complementary institutional mechanisms, genuine independence of directors from management may prove to be elusive. The Milgram experiment showed how ordinary individuals out of a sense of loyalty to an experimenter (the authoritative figure) were willing to cause extreme harm to perfect strangers disregarding their own assessment of the consequences of such actions on the instructions of the experimenter. Morck (2004) drawing an analogy between the experimental set up and the corporate board observes that the directors of a board often owe allegiance to the CEO (possibly because teh CEO has the most say in nominating them) and would, out of a sense of loyalty, seldom oppose the CEO's decisions even at the expense of a director's fiduciary duty to the shareholders. An extension of the results of Milgram's experiment would in fact suggest that directors enjoy a positive sense of well-being from their "reflexive obedience" to the CEO. If independent directors are subject to the influence of an "authoritative" CEO, this might explain the weak relation between firm value and board independence in general, and in emerging economies in particular.

The possibility of independent directors acting as the obedient agents of a powerful CEO is a distinct possibility in emerging economies given that our earlier analysis shows that corporations of these economies are dominated by controlling shareholders who often occupy important positions in corporate boards, and are therefore in a position to exert

significant influence on the selection and appointment of independent directors. Similar observations are applicable with respect to India given that a large proportion of the boards in India are additionally characterised by CEO duality; also there is a significantly increasing trend of boards having promoters doubling as chairmen in boards. It has generally been the practice that promoters often identify and induct outside directors with whom they have a certain comfort level, or who are well-known personalities who can bring credibility to the board (–FICCI-Grant Thornton, 2009). An analysis of multiple directorships that points to the existence of an inner circle with respect to independent directors (Sarkar & Sarkar, 2009) sitting on corporate boards of family-owned group affiliates also reinforces this possibility.

However, while reflexive obedience is an innate characteristic of human nature, variants of the Milgram experiment do show that altering the environment of the interaction can substantially diminish, and in some cases, eliminate this reflexive obedience. The Milgram experiment suggests that "dissenting peers" and "rival authorities" substantially weaken the subject's loyalty to an authoritative figure and stimulate independent thinking. While the results of the Milgram experiment that were conducted in different social settings may not be fully applicable to evaluate the behaviour of directors on corporate boards, the results from this experiment do provide insights that highlight the importance of designing an effective board process that can help independent directors to exercise their independence. Regulations in many developed countries seem to be borrowing the insights from the Milgram experiment while undertaking governance reforms with respect to corporate boards. Several policy initiatives have been instituted in countries like the US and the UK which have been incorporated in listing regulations and best practice codes to reduce the potential cost of dissent by independent directors on boards with powerful CEOs, and to allow independent directors to act as a peer group independent of the CEO. This is perhaps in response to a growing recognition that rewarding consent and discouraging conflicts can not only have an adverse effect on both the CEO and the company performance, but also—in the absence of the "monitoring and criticism

of an active and attentive board"—cause a series of small problems that could eventually blow up to a crisis (Jensen, 1993).

Among the policies designed to make independence more functional are (1) the requirement to have a Nomination Committee comprised entirely of independent directors which (in addition to other functions) would have the responsibility of identifying candidates qualified to become board members and overseeing the evaluation of the board and management;[5] (2) the appointment of a senior independent director; and (3) the separation of the positions of CEO and Chairman. In addition, the responsibilities of directors prescribed in most governance codes require meetings with other members of the board in executive sessions without the presence of the CEO/chairman at least annually, to evaluate and appraise the performance of the CEO/chairman. An additional requirement is that non-management directors of a company meet at regularly scheduled sessions without members of the management. These regulations have the potential to reduce the misplaced loyalty of independent directors, and enable them to be effective gatekeepers as evidenced by the different variants of the Milgram experiment that found the subject to act more responsibly when removed from the proximity of the experimenter, and when the experimenter was challenged by an equally imposing peer (Morck, 2004).

7. Do the Clause 49 regulations on board of directors address the ground realities in India?

The discussion in the previous section suggests that it is not enough to have an independent board; an enabling environment that helps independent directors to exercise their independence is also required. Regulations in emerging economies—many of which exhibit the strong presence of controlling shareholders—have to take care of the ground realties of their respective countries. Next we look at whether the governance regulations with respect to the composition of corporate boards and the framework supporting the exercise of independent judgment take into account the ground realties in India.

Commencing in 1998, and through a series of committee recommendations in the following years, the governance regime in the

country has received serious attention, culminating (in the case of publicly traded companies) in the now famous Clause 49 of the Stock Exchange Listing Agreement, which was first notified in February 2000,[6] and became applicable in a phased manner to all listed companies by March 2003.

Under Clause 49, listed companies are required to have no less than half of their board composed of non-executive directors; concurrently, it also mandated at least half the board to be composed of independent directors where the board chair and the CEO were the same individual, or where the board chair was also a promoter, or related to a promoter, or management.Similarly, the set of criteria defining the "independence" of a director itself underwent significant changes in consonance with international best practices, from being largely subjective to becoming more objective.

While board independence has been defined globally based on a minimum number or proportion of independent directors, the challenging issue for policy makers and academics alike has been to define the independence of a director in objective terms based on "relationship standards." The evolution of the independence standards in India as highlighted in Box 1 is a case in point. In the original version of Clause 49, a director could be considered independent if the individual (apart from receiving director's remuneration) did not have any other material pecuniary relationship or transactions with the company, its promoters, its management, or its subsidiaries, *which in the judgment of the board* (emphasis added) may affect the independent judgement of the director. As the Naresh Chandra Committee on Corporate Audit and Governance recognised, while such a broad definition of independence may be pragmatic and flexible, it is "circular and tautological," and a more rigorous definition needed to be adopted. The subsequent amendments to Clause 49 addressed such concerns and itemised in detail a more stringent and objective checklist that a director has to satisfy to be deemed independent. The revised definition of independence in India came on the heels of the enactment of the Sarbanes-Oxley Act, 2002 in the US following the Enron scandal, and the incorporation of a set of "bright line" tests for independent directors by the NYSE in their new listing standards in 2003.

Box 1: Major revisions of Clause 49 of Listing Agreement with respect to board composition and independence

Clause 49 (original)* February 21, 2000	Clause 49 (revised)** October 29, 2004	Clause 49 (revised)*** April 8, 2008
Board composition The company agrees that the board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors. The number of independent directors would depend whether the Chairman is executive or non-executive. In case of a non-executive chairman, at least one-third of board should comprise of independent directors and in case of an executive chairman, at least half of board should comprise of independent directors. **Determination of Independence** 'independent directors' means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgement of the board may affect independence of judgement of the director.	**Board Composition** Similar as February, 2000 **Determination of Independence** *Revised* For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who: a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of thedirector; b. is not related to promoters or persons occupying management positions at the board level or at one level below the board; c. has not been an executive of the company in the immediately preceding three financial years; d. is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following: (i) the statutory audit firm or the internal audit firm that is associated with the company, and (ii) the legal firm(s) and consulting firm(s) that have a material association with the company. e. is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and f. is not a substantial shareholder of the company i.e. owning two per cent or more of the block of voting shares.	**Board Composition** *Additional qualification for boards with non-executive chairman* "If the non-executive Chairman is a promoter or is related to promoters or persons occupying management positions at the board level or at one level below the board, at least one-half of the board of the company should consist of independent directors." **Determination of Independence** *Similar as October 2004*

* See Circular No. SMDRP/POLICY/CIR-10/2000, dated, February 21, 2000. http://www.sebi.gov.in/

** See Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 October 29, 2004. http://www.sebi.gov.in/

*** See Circular No. SEBI/CFD/DIL/CG/1/2008/08/04, dated April 08, 2008. http://www.sebi.gov.in/

While the Clause 49 regulations did a commendable job in specifying board composition, especially in recognising the promoters' presence on corporate boards, and defining the concept of independence, it fell short on one very crucial issue—requiring the companies to constitute a Nomination Committee for the selection of independent directors. The failure to insist on the formation of a Nomination Committee is particularly striking given the reality of family dominance in Indian companies, and the documented evidence of powerful promoters occupying dual positions of CEO and Chairman, with correspondingly large power to influence the selection and election of independent directors. Other shortcomings of the Clause 49 regulations with respect to board independence are the failure to recommend separate meetings without the management, and the appointment of a senior independent director in line with the requirements and recommendations of the best practices in other countries. Currently the Clause 49 regulations only require that two-thirds of audit committees be composed of independent as compared, for example, to the US Sarbanes-Oxley mandate of a fully independent audit committee. There is no mandate for a compensation committee as is required in many developed countries. Thus controlling insiders in Indian companies continue to exert significant influence over the choice of independent directors and the determination of their compensation.

Perhaps the institutional setting and the influence and evolution of family business play a dominant role in determining the pace of governance reforms. But these reforms have to be undertaken in the near future to improve the standards of governance particularly in order to signal to the outside world that Indian companies comply with the best practices adopted in many countries across the world.

8. Board governance in India: Way forward

These issues of behavioural and procedural aspects of director and board independence clearly suggest the path for future reforms in India in these areas, which need to address the conditions that break the "reflex obedience" to loyalty, and enable independent directors to exercise their judgment. The following aspects deserve consideration.

Board composition

The board should consist of a majority of independent directors. Adequate representation of independent directors on corporate boards is necessary to make their voice heard and their decision count, especially due to promoter dominance in Indian companies. The more stringent minimum requirement of independence for boards with executive or non-independent chairman recognises the need to minimise disproportionate CEO powers in decision-making that is endemic to such boards.

The Companies Bill of 2009 has however proposed a minimum of one-third of the total number of directors, irrespective of whether the Chairman is executive or non-executive, independent or not. This recommendation ignores the ground reality of promoter dominance in Indian companies. The Companies Bill's laudable aim to return the ultimate power over corporate decisions to shareholders has to be tempered by the fact that promoters in most of the large listed companies are majority or dominant owners. The institution of independent directors—the key mechanism to protect the interests of minority shareholders—would thus be largely dysfunctional, being overly vulnerable to the influence of the controlling shareholders. Under the 2009 Bill it would be possible to have boards with two-thirds of inside directors with a promoter as CEO and/or Chairman, leaving independent directors virtually powerless to preempt potential managerial abuses. One should be moving towards a majority of the board being independent. With this, there will also be no need to persevere with the distinction of board independence based on the affiliation of the Chairman. Even otherwise, Stock Exchanges could and should seriously explore the possibility of demanding higher standards of board independence from Indian companies than is prescribed by legislation.

It is often argued, that any over-specification of independence criteria may actually lead to an erosion of board contribution since those who bring in their domain expertise—the so-called "value directors" who form the "brain trust" of companies (Clarke, 2007) —may not qualify as independent because of the professional level fees that may have to

be paid to recruit and retain them. This argument does not have much merit because nothing stops companies from hiring them as independent consultants and advisors if their services are required.

Nominee directors

Nominee directors should not be counted as independent directors. A particular issue specific to India regarding independent directors is the treatment of nominee directors who are appointed by financial institutions on account of their significant equity and debt holdings in the company. Clause 49 stipulates that “Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be an independent director”.[7]

Independent directors are fiduciaries of shareholders interests. Nominee directors by definition represent the interest of the financial institutions that nominate them. If the financial institutions are only equity holders then their interests will coincide with that of the other shareholders. On the other hand, if the financial institutions are also significant debt holders (as is often the case) then the interest of such nominee directors will diverge from that of the shareholders. These directors are then less likely to support risky projects which are otherwise economically profitable because as debt holders they do not benefit from any increased returns generated by the company. Their main task would be to secure the fixed stream of debt servicing payments to their parent institutions. Such nominee directors cannot be considered as independent directors. In addition, there is further conflict of interest since the institutions that appoint nominee directors are often major players in the stock market in respect of shares of the companies in which they have nominees.

One argument advanced for having nominee directors is that they are required to protect public interest, as these financial institutions as repositories of public savings. However, protection of public interest can be easily accomplished by writing suitable covenants in debt contracts. If these institutions wish to have their directors because of their equity holdings then they could as well get them elected using the same process

available to all other shareholders instead of seeking any automatic representation rights, and be satisfied with the same information inputs as are available to other directors and shareholders.[8]

Almost all corporate governance committees constituted in India have all suggested that nominee directors should not be treated as independent directors and it is time that these recommendations are mandated. Although the provisions of Companies Bill (2009) seem to imply this disqualification, greater drafting clarity may be necessary to establish this beyond doubt (see Clause 132.(5) of the New Companies Bill 2009). At any rate, stock exchanges can help by clearly mandating such a disqualification in unequivocal terms.

Nomination committee

Regulations should require the immediate constitution of an independent Nomination Committee. The insistence on higher board independence will have little meaning without the setting up of proper procedures for selecting independent directors. Foremost among these is the need to have a mandatory Nomination Committee composed entirely of independent directors to identify a pool of independent directors for the board to choose from and recommend for shareholders' approval. All independent directors who are shortlisted by the Nomination Committee should be required to sign an "affirmative declaration of independence" stating that they fulfill all the prescribed independence requirements. This may be particularly important given that it may not be possible to lay down all the "exclusions" that lead to the rejection of "presumption of independence." As current NYSE Listing Regulations mention, "it is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company" (Section 303A.02 of NYSE Listed Company Manual).

Notwithstanding the screening of independent directors by the Nomination Committee, promoters in many Indian companies are in a position to exercise their preference in the choice of independent directors

by virtue of having more than majority ownership. Minority shareholders therefore may have to be proactively given a minimum representation in the board of directors through cumulative voting (as in Chile), or through mandatory representation of minority shareholders on the board of directors (as in Italy).

Effective board process

The environment that helps independent directors to exercise their independence should be strengthened. Coupled with the constitution of a majority independent board, other reforms will be required to set up effective board processes that create a more enabling environment for independent directors to exercise their independence, such as the nomination of a *Senior Independent Director,* and provisions requiring outside directors to convene *meetings without the management*. As the KPMG Audit Committee Institute points out, relevant information that *clearly outline the agenda items of board meetings* as well as give *sufficient time to prepare for the meetings* are some of the most important factors that can lead to the strengthening of the institution of independent directors, and the regulation ought to mandate these requirements as part of the duties of company managements.

Tenure of independent directors

There is a need to set a limit on the tenure of independent directors, and to recognise that concentration of directorships contributes to erosion of independence. Inextricably related to the issue of independence is the tenure of independent directors. In the case of long-serving directors, their willingness and ability to discharge their duties and responsibilities independent of the management are open to question. The tenure distribution of independent directors based on a sample of over 2200 listed companies (Table 4) shows the mean tenure of independent directors to be 8 years. 10% of the independent directors have tenure of 14.5 years or more, while 5% have tenure in excess of 16.75 years, with the maximum tenure reaching as high as 37.50 years. There are significant differences in the tenure characteristics of independent directors serving

on the boards of group and standalone companies. The mean tenure of independent directors in group companies is higher by about two years compared to that in standalone companies. There is a widening of this difference as one moves up along the distribution. Thus while 5% of the directors in standalone companies have tenure of 15.25 years or above, the corresponding figure for group companies is 19.67 years. The maximum tenure of independent directors in group companies is 36 years compared to 28 years in standalone companies.

Table 4: Tenure of independent directors in Indian companies (2008)

	All Companies	Group Companies	Non-Group Companies
Min	1.00	1.00	1.00
10th Percentile	3.00	3.33	3.00
First Quartile	4.25	5.00	4.00
Mean	7.85	8.89	7.12
Median	6.80	7.80	6.00
Upper Quartile	10.15	11.50	9.00
90th Percentile	14.50	15.57	13.00
Max	37.50	36.00	28
Percentage of companies with mean tenure of independent directors greater than 9 years	0.30	0.39	0.25

Source: Author’s calculation based on data on 2217 listed companies contained in the Directors’ Database, Bombay Stock Exchange in association with Prime Database.

A similar problem is also evident in the case of concentrated directorships with people on the boards of various group or affiliated companies. Since the primary reasons for potential tenure-based erosion of independence are familiarity and alignment, the prospects of such erosion are not limited to just one company as a standalone entity but to a group of companies and other entities with affiliations with the same set of promoters. A recent analysis of multiple directorships in Indian companies (Sarkar & Sarkar, 2009) identifies the existence of an “inner circle” with respect to independent directors sitting on corporate boards of family-owned group affiliates—about 67% of independent directors in group affiliates are also located within other group affiliates, with

43% of directorships on an average concentrated within a *single* group. These estimates were found to be substantially higher than corresponding estimates for independent directors of non-affiliated firms.

Regulations in most countries do not currently impose any upper limit on the number of years that an independent director can serve on company boards. Clause 49 requires that independent directors do not have an aggregate tenure that exceeds nine years, but this is only a non-mandatory requirement (and that too only with respect to a single company which does not recognise tenures in affiliated company boards). In most cases the law requires that a fraction of the independent directors retire every year, but they are eligible for re-election. This is in marked contrast to the fact that the law in almost every country requires a rotation of the audit partner. The principal reason behind audit partner rotation is the notion of "familiarity threat" whereby the auditor can potentially lose his/her objectivity and independence as a result of long interactions with the management. While this notion of rotation is very well accepted with respect to auditors, it is not clear why the same notion should not be applied by regulators with respect to independent directors whose interaction with inside management is more frequent than in the case of the external auditors. Perhaps the regulators put added emphasis on the advisory or strategic role that independent directors are supposed to play on company boards compared to the monitoring role that these directors are supposed to play to protect shareholders' interest.

However, in light of the major corporate failures around the world and the seeming inability of the board to act in time, there is a growing recognition that the regulations should emphasise the monitoring role of the independent directors as fiduciaries of the shareholders' interests compared to their strategic or advisory role. With this recognition, the tenure of independent directors has become a critical issue in governance. Though proposed tenure restrictions will need to balance the benefits of better advice that come with the experience of serving on the board for many years with the reduced independence that comes from long association with a company and its management, a cut-off level for tenure

for independent directors must exist. Therefore there is a strong argument for moving the non-mandatory provisions on tenure restriction of Clause 49 to the list of mandatory requirements. In the absence of any empirical guidelines, such tenure restrictions will necessarily have to be framed exogenously to begin with.

Emphasise the monitoring role of independent directors

Finally, the regulations must clearly specify the primary role of the independent directors. Under the current regulations (in India and elsewhere), independent directors are required to wear "two hats" (Ezzamel & Watson, 1997)—one for discharging their advisory role, and the other for discharging their monitoring role. It is highly doubtful if independent directors can really fulfil their role of monitoring within management and hold them accountable for poor performance, if they themselves have been involved in advising management for the company's strategy and vision. It is time to start recognising that the primary role of independent directors is to act as monitors of management and not to advise them on how to improve company value. This is the task of the inside managers and the value directors, i.e. non-executive directors who are specifically hired for their professional advice. The primary responsibility of the independent directors should be to act as monitors especially in areas such as information disclosure, executive remuneration and board governance because these are the areas where controlling insiders and outside shareholders' interests are most likely to diverge. Moreover these are the types of decisions where independent directors' influence and monitoring abilities should be the greatest because such decisions are less likely to involve issues directly related to the management's technical expertise. The very origin of the corporate governance problem dictates that monitors are required to reduce agency costs, and independent directors are primarily expected to fulfil this monitoring role. This may require changes in the Company Law which currently does not make any legal distinction regarding the duties of executive and independent directors. Alternatively, stock exchange regulations can specify a separate charter for the duties of the independent directors that can specify their responsibilities.

Initiate formal training of independent directors

Independent directors should be given proper training to make them aware of their rights and responsibilities encoded under the various statutes like the Companies Act of 1956, and the Clause 49 regulations. In particular, this training should emphasise the fiduciary role of the independent directors as protectors of shareholders' interests. Too often, independent directors seem to think that they are present on the board as advisors.

Proper training and certification of independent directors would increase the directors' understanding and awareness of what it means to be an independent director, and will help to create a pool of well qualified professionals from where companies can make their choice. The Professional Non-Executive Director (PRO NED) program that was started in 1981 in the United Kingdom, and the National Association of Corporate Directors (NACD) that was formed in 1977 in the US have been instrumental in educating directors of their governance responsibilities, promoting employment of better and well informed nonexecutive directors, and helping companies seeking to employ independent directors on their Boards. The Australian Institute of Company Directors (AICD) has a formal course in director training that leads to an internationally recognised qualification. The Indonesian Institute of Corporate Directorship, and the Philippine Institute of Corporate Directors are also contemplating instituting formal training for independent directors. There is a case for similar professional training and continuing education in India for those who aspire to serve as independent directors of companies.

In conclusion, the institution of independent directors remains a crucial internal mechanism in ensuring good corporate governance in companies. This importance is heightened in the context of India where the protection of minority shareholders remains the specific goal of the regulator. In addition, good corporate governance is required for attracting outside capital and promoting the growth of Indian companies, and ultimately accelerating the nation's economic growth. Governance risk is a key determinant of

the market pricing of listed securities. A high independence quotient of a company's board could be perceived to be reassuring to the absentee shareholders, thereby reducing the risk premium that would otherwise be required, and consequently reducing the cost of capital to the company. Strengthening independence so that this objective is better subserved also provides a strong business case for strengthening board independence. Admittedly, there are many issues that need to be addressed. However, with proper processes for selecting independent directors, giving them the necessary training, creating the right environment where they can exercise their independence, rewarding them suitably, and making them aware of their duties and responsibilities, the institution of independent directors can be a powerful governance mechanism for the protection of minority shareholders in India.

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Notes

[1] This is the standard cut-off applied in the literature to define widely-held firms (see Faccio & Lang, 2002; La Porta et al. 1999; Claessens et al. 2000).

[2] See Section 303A.00 of the Listed Company Manual of NYSE Stock Exchange. http://nysemanual.nyse.com/lcm (Accessed on 18 August, 2010).

[3] For details, see the Listed Company Manual, NYSE Stock Exchange. http://nysemanual.nyse.com/lcm/ (Accessed on 18 August, 2010).

[4] Stanley Milgram, an Assistant professor of psychology at Yale, began a series of experiments in 1961 in social psychology to test how the innate quality of loyalty could make individuals take actions which do not reflect their independent thinking when instructed to do so by an authoritative figure. The Milgram experiment showed that people could suppress their internal ethical standards if these came in conflict with loyalty to an authoritative figure. Based on variants of the experiment (where it was found that changing the environment of the experiment had a substantial effect on the obedience rate of the subjects), Milgram concluded that peer rebellion, disputes between rival authority figures and lack of proximity from the experimenter helped to bring back rational judgment and reduce the effect of loyalty and thereby undercut the experimenter's authority (Milgram, 1963, 1974).

[5] See NYSE Listing Requirements for a detailed list of the functions of a Nominating Committee.

[6] See Circular No. SMDRP/POLICY/CIR-10/2000, dated February 21, 2000. http://www.sebi.gov.in/ (Accessed on 18 August, 2010).

[7] See SEBI/CFD/DIL/CG/2004/12/10) circular dated October 29, 2004. "Institution" for this purpose means a public financial institution as defined in Section 4A of the Companies Act, 1956 or a "corresponding new bank" as defined in section 2(d) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 [both Acts].

[8] See the dissenting view recorded in the Narayana Murthy Committee report, paragraph 3.81.4., on financial institutions receiving price-sensitive information by virtue of their board status.

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