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Corporate Governance and the Indian Private Sector

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The following study examines the issue of corporate governance in the context of large private sector companies in India against a regulatory background that is changing rapidly. Based on over 170 interviews with a very wide range of business representatives, including CEOs, non-executives, fund managers and audit firms, the two reports which make up the study highlight the ineffectiveness of boards in Indian companies, the lack of transparency surrounding transactions within business groups, the divergence of Indian accounting practices from international standards, and the changing role of, and controversy surrounding, institutional shareholders. Respondents concurred on the failure of the board as an institution of governance in Indian companies, despite the large presence of non-executives. The authors argue that regulatory intervention needs a much stronger definition of 'independence' for directors, in line with best practice definitions now adopted in the US and UK, as well as the mandatory introduction of nomination committees. In the accounting field, the most serious lacuna is the lack of consolidation of accounts, even if 51% may be too high a threshold for consolidation in the Indian context. Finally, the presence of institutional nominees is a unique feature of Indian corporate governance and there has been a powerful corporate lobby in favour of removing them from boards. While this would reduce the accountability of Indian boards even further, the reports argue that a more active approach to corporate governance on the part of institutional investors requires larger changes in the nature of the FIs' ownership and control by government, greater autonomy for institutional managers, and the active development of a market for corporate control.

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The study on which the following reports are based was conducted over two and half years from April 1998 to the latter part of 2000 and involved interaction with a very large number of respondents in the financial and manufacturing sectors. Of well over 140 faxes sent out from Oxford during that period, the overall response rate was around 70 per cent! We are profoundly grateful to all the individuals we met for their generous commitments of time and ideas in the course of interviews that normally interrupted a packed working day. Their names have been put together in the list which appears at the end of this report, as there seemed to be no other way of thanking them collectively.

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Contents

Corporate Governance and the Indian Private Sector
Jairus Banaji 4

Governance of the Private Sector: Regulatory Issues
Gautam Mody 51

List of respondents 70

Corporate Governance and the Indian Private Sector

Introduction

The Indian corporate sector has seen substantial and significant changes in the last ten years. The economic reform programme ended decades of relative isolation, eroding both the lethargy and the traditional sources of dominance of a large and powerful class of family businesses. A major part of that story is about the way global forces have been reshaping the Indian business sector, with strong competitive pressures on Indian companies, a reworking of the financial landscape (the emergence of a modern financial system), and far-reaching changes in the stock market. With investments in Indian equity by foreign institutional investors, standards of research have improved considerably and the top 200 companies are heavily researched today. There is also a close and regular interaction between managements, research analysts and fund managers. One implication of all this is a huge premium on transparency. On the other hand, few corporates relish transparency, in part because, as one industrialist said in the course of this study, 'One of the banes of Indian family-owned business is keeping their holding close to their chest'. Corporate governance is at the heart of the drama of liberalisation, because the key issues are those of ownership and control, as well as management integrity, accountability and transparency, and the impact these features have on the growth of the economy and the vitality of the business sector. The subordination of boards to management, self-dealing, manipulation of accounts, and corruption in the allocation of finance have all contributed to the endemic lack of credibility Indian businesses have suffered from, and a crucial part of the reform of the corporate sector is how soon and how consistently those legacies can be discarded and overcome. India is still a developing country and it can scarcely afford to live with the incubus of a corporate system that constrains growth because business families are unwilling to yield control and because the management of companies lacks credibility with investors. Corporate governance is therefore crucial, not in the mechanical sense of a magic wand that will help companies to boost their share prices, but in the longer term sense of creating a credible and professionally driven business system that has the potential to transform living conditions for the vast majority of the population. This is a huge agenda which involves more than the corporate sector in the narrow sense and includes a wide range of issues such as why the enforcement of laws is so poorly developed in India, and how a culture of professionalism can take root in the country against the mediocrity and corruption that pervade almost every aspect of public life.

Corporate governance is also about global consistency in the rules governing international business. These rules can be conceived in two rather different ways, however: (a) in a less comprehensive manner, to mean primarily the accountability of boards to shareholders and the ways in which that can and should be improved; or (b) more comprehensively, to cover wider issues which have a bearing on business operation and the rights of shareholders and other stakeholders. In the latter, more comprehensive, sense, corporate governance would include areas such as the international alignment of accounting standards, rules for the efficient functioning of a corporate control market, and the governance of securities markets, notably the issue of insider trading. Proof of this duality of perspectives is contained in the SEBI Code itself, for the code verges on major issues whose resolution is left to other committees and pieces of regulation, notably, the upgrading of Indian accounting standards and disclosure requirements, insider trading regulations, and the takeover code. But whichever perspective we adopt, consistency matters because today the same powerful set of institutional investors straddle diverse markets internationally and seek regulatory and business regimes that will minimise the 'cultural' risk to their investments.

The dominant academic view frames the issue of corporate governance essentially as one of the 'agency costs' inherent in the separation of ownership and control. The assumption here is that the dispersal of shareholding in the large modern publicly quoted corporation created a power vacuum which was filled by the emergence of a cadre of professional corporate managers who came to form a powerful and unsupervised constituency in modern industry.[1] However, the assumption of dispersed ownership is seen to be limited in at least two ways once we extend this largely American model to the contemporary world and to corporate regimes outside the US and the UK. First, the dispersion of shareholding cannot be, and was never, a valid description of those situations, such as in Europe,[2] India, and East Asia,[3] where corporate ownership patterns have traditionally been highly concentrated, even as many of these companies have gone public and listed their shares on the stock exchange. Second, even in the Anglo-American markets, the last four decades of the twentieth century have seen a gradual but dramatic increase in the percentage of shareholdings under institutional ownership, leading to a significant *re*-concentration of capital in the hands of pension funds, insurance companies, etc., and through them of the fund management industry generally.[4] In fact, it is these latter developments which underpin the emergence of the contemporary debate on corporate governance and in particular the corporate governance platform of the 1990s, associated, in the public mind, with the Report of the Cadbury Committee in the UK, the activity of public pension funds in the US, and the sporadic upsurge of shareholder activism in various parts of the world.

In India, the surfacing of the issue in this modern or contemporary sense is certainly part of these worldwide trends, and, in particular, of the cultural influence of Cadbury-style ideas of corporate reform (or self-reform) through 'self-regulation'.[5] In India's case the influence of Cadbury was strongly emphasised by Sir Adrian Cadbury's personal if emblematic association with the highly publicised meetings of the CII, where Indian business made its first public statements on the need for companies take the issue of corporate governance seriously and institute minimal reforms in the functioning of boards and levels of transparency.[6] Since then we have seen not one but two codes of corporate governance being advertised, one perhaps with greater authority or sanction than the other, as well as a considerable public debate on the desirability of governance reform in the Indian corporate sector and the role of the financial institutions in the whole process. In this report we propose to survey some of the key issues and adopt, deliberately, a critical stance vis-à-vis major players in the Indian governance debate. The key issues, as we see them, are (1) the independence of boards, (2) corporate reporting practices, and (3) the role of institutional investors. We have accordingly structured the following report to reflect these major themes, after a preliminary section that deals with codes of corporate governance. The third issue here *should* lead to a consideration of the nature of the Indian market and raise the issue of how far reform of company governance can succeed, or indeed make sense, while the market as a whole is permeated by staggering levels of manipulation and insider trading, regulation has failed to curb these, and there is simply no systematic pursuit of non-compliance. However, the subject of insider trading and market governance is best left to a separate report, and we shall only note in passing that self-regulation is not a *substitute* for regulation but presupposes both strong regulatory frameworks and the willingness and ability to pursue offenders.

It may be helpful to preview the main conclusions of each of the three areas into which this part of the report is divided.[7] Firstly, the most striking and commonly agreed feature of corporate governance practices in Indian private sector companies has been the widespread and widely perceived failure of boards. The board simply does not exist as an institution of governance in the private sector, except in a handful of companies. In a sense this is equivalent to saying that truly independent directors are rare in Indian companies. Secondly, the presence of foreign institutional investors has been a key driver behind the gradual improvement in disclosure standards. But levels of disclosure remain poor (major recommendations of the Bhave Committee remain unimplemented), accounting standards weak, and Indian corporate structures low in transparency. Thirdly, the institutional nominee system has been subjected to widespread criticism. There has also been a strong campaign to remove nominees from boards. However, undermining the institutions' *right* to board representation is only likely to reduce the accountability of boards even further. The solution lies in constituting a panel of professionally qualified independent directors to serve as institutional and public shareholder nominees. Accountability can scarcely work in the abstract, as every dominant shareholder is aware.

1. Codes of Corporate Governance

In February 2000 the Securities and Exchange Board of India issued a letter to all the stock exchanges proposing that 'a new clause, namely clause 49, be incorporated in the listing agreement'. Clause 49, called 'Corporate Governance', contains eight sections dealing with the Board of Directors, Audit Committee, Remuneration of Directors, Board Procedure, Management, Shareholders, Report on Corporate Governance, and Compliance respectively. The salient features are as follows:

- In future at least one-third of the board should consist of independent directors, 'independence' being defined as 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 independence of judgement
- Companies shall have a 'qualified and independent' audit committee with a majority of independent directors
- The Annual Report shall disclose details of the remuneration of directors
- The Annual Report should contain a Management Discussion and Analysis 'as part of the director's report or as an addition there to'

- Annual Reports shall contain a separate section on Corporate Governance detailing compliance with the mandatory and non-mandatory requirements proposed by SEBI.

While the letter to the stock exchanges describes the various provisions as ‘requirements’, both the draft and the final report of the Kumar Mangalam Birla Committee refer to them as ‘recommendations’. The Committee saw itself drafting recommendations, presumably because it saw itself pursuing an exercise in voluntary compliance (‘self-regulation’). However, taken together these proposals may not go far in bringing about the kind of reform that can bring the mainstream of businesses in India into line with best practice in corporate governance. There are at least three reasons why this is so. First, the SEBI Code itself departs from international best practice in key respects which are outlined below. (A realist theory of regulation would argue that regulators do not work in a vacuum but are subject to powerful pulls and pressures within the domestic market.) Second, it is still too early to say how far listing agreements can be an effective mechanism of compliance with a code of best practice. The fact that SEBI has since suggested to the government that ‘the listing agreement be substituted by listing rules which are statutory in nature’ suggests that the exchanges may not want or be able to play the role of compliance monitors. Indeed, there is considerable scepticism on this score. Third, the Cadbury model, which is the ostensible inspiration behind SEBI’s code, is itself open to a number of criticisms. Before discussing these, it may be helpful to start with the model itself and restate its essential features.

The Cadbury Model

A major business innovation of the 1990s involved the rapid spread of codes of corporate governance worldwide, following the publication in 1992 of the report of the Cadbury Committee in the UK. The new feature of Cadbury was a model where market-based regulation, institutional investors, and codes of best practice would work in synergy to produce greater transparency and accountability in business, boosting investor confidence and contributing significantly to the liquidity of the market. The market was seen as the general medium of accountability. However, for the market to be able to exert accountability pressures on companies, it needs a benchmark. In Cadbury-style corporate governance that benchmark is a system of rules and principles of good corporate governance, which are expressed in a formal way in codes of best practice. Such codes are self-regulatory, with one important qualification, namely, that amendments are made to the listing agreement to create an obligation on companies to state how far they comply with the code. Secondly, Cadbury acknowledges the strategic disparity between classes of shareholders, namely, the ability of institutional investors to influence corporate behaviour by contrast with the relative apathy and or impotence of small shareholders. Finally, the codes themselves are largely about defining and formalising management’s accountability to the board, and, through the board, to the shareholders as a whole. Central to the professional character and independence of boards is the role the independent non-executive directors are expected to play and the formal mechanisms (i.e. board committees) through which such directors are expected to supervise management. The existence of board committees controlled by independent directors creates a presumption of formality and transparency in the procedures for appointing new directors to the board and developing a policy on executive pay. Cadbury assigns special importance to audit committees, since a major part of the brief of independent directors is the ability to exercise financial supervision over companies and reassure investors that the company's 'financial controls and accounting systems are of a high standard'. Nomination committees are also important because they ensure that the selection of the board is grounded in a formal and transparent procedure, and independent of management. Independent directors are also expected to play a major role in establishing and reviewing the compensation of the CEO and senior management. It is now considered best practice for these three committees (audit, nomination, and remuneration) to be staffed entirely or largely by independent directors, which raises the issue of who counts as an independent director, or how independence is construed.

Having summarised the prevailing Anglo-American approach to corporate governance in this way, one should note that Cadbury makes several assumptions. It assumes a corporate culture or system where there is *already* a widespread and well-established separation of ownership and control. Cadbury is not tailor-made to a context where dominant shareholders, e.g. promoters, control management and where the corporate governance problem is chiefly one of the protection of minority shareholder rights. The assumption of dispersed ownership explains why there is little emphasis in Cadbury on the equitable treatment of different groups of shareholders. Cadbury also assumes that supervision can effectively be exercised within the framework of a unitary board where independent directors are expected both to contribute to management decision-making and to monitor the decisions management makes. Third, the model assumes a powerful external shareholder base which is strongly motivated to monitor companies. Finally, of course, at the most general level Cadbury assumes that 'accountability can be best achieved through a voluntary code coupled with disclosure'. Of course, compliance with the Cadbury and Combined Codes 'is not entirely a matter of self-regulation', since the listing rules of the London Stock Exchange 'provide important backing' in having the status of subordinate legislation.[8] The substance of the SEBI Code has likewise been incorporated as Clause 49 of our own listing agreements,[9] with the notable difference that in the UK the "Yellow Book", as it is called, is now within the jurisdiction of the Financial Services Authority, SEBI's counterpart, and no longer with the exchange.[10] Even allowing for the legal status of the listing rules, 'self-regulatory structures are prone to a number of criticisms'. Among these the most important, perhaps, are that 'they are designed with large, well-organised, well-resourced enterprises in mind and fail to deal with those who really need to be regulated'; also that 'they are low on accountability' and 'tend not to enjoy public confidence'. Enforcement is particularly problematic: it is doubtful if most exchange authorities would seriously contemplate striking-off any company for failure to comply with a code of best practice.[11] So the general issue here is whether self-regulation is a sufficient (and sufficiently strong) form of accountability.

Limitations of the SEBI Code

Sensing this difficulty, the drafters of our own code of corporate governance decided to divide their recommendations into two types, 'mandatory' and 'non-mandatory'. One is not aware of any other governance code which refers to any of its recommendations as 'mandatory', and indeed it is peculiar to describe a *recommendation* as mandatory, since a recommendation is by definition advisory in nature. However, this is a matter of language, the key point to bear in mind is that the code adopted by SEBI describes itself as a 'statutory' code and wants the self-regulation of business to have the force of law. More substantially, the actual provisions of the code deviate from international best practice in important respects. This is particularly clear when the code is compared with other codes of corporate governance worldwide. The comparison presented here draws on 15 codes of corporate governance, including those of France, Germany, Belgium, Spain, 2 in the UK, 2 in the US, and four from what may be described as emerging markets. Among the best of these are the OECD Principles of Corporate Governance and the Corporate Governance Principles drafted by the European Association of Securities Dealers (EASD) earlier this year. In contrast to both the Cadbury and the SEBI Codes, the OECD Principles show a much greater emphasis on the equitable treatment of all shareholders. Cadbury's assumption is dispersed ownership, and SEBI's overdependence on Cadbury seems to have carried over some of the consequences of that assumption into a market where concentrated ownership is the chief source of the problem. Of the various codes only one (EASD's) is explicit in its perception that the nature of the corporate governance problem is not the same in markets with dispersed ownership and those with a substantial presence of controlling blockholders.

Looking at the 15 codes as a whole, international best practice recommendations can be broadly classified into three areas: 1) the independence of the board, 2) the responsibilities of institutional investors or shareholders, and 3) the transparency of business structure and operation. Almost all codes are agreed on the need for the board to have a substantial degree of independence from management. Where they differ is in the details and how tightly or loosely they define the independence of so-called independent directors. SEBI's definition is rather loose because it restricts itself to only one feature, namely, whether directors have 'any material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries' which (in the opinion of the board) may affect their independence of judgement. But if the issue is independence of judgement, this can surely just as well be affected by a director having no such relationship but being, for example, a former executive of the company or a member of the immediate family of an individual who has been an executive in the recent past. Contrast this with a best practice definition such as that proposed by CalPERS in the US or the National Association of Pension Funds in the UK. The importance of this preliminary issue is that unless we construe independence in a sufficiently realistic way, none of the recommendations on the independence of the board, e.g. that the chair of the audit committee should be an independent director, will have much meaning. This is why in the US the new Audit Committee rules pay special attention to this question, with both the NYSE and the NASD enhancing their definitions of independence.[12] Secondly, almost every code recommends nomination committees to control the selection of the board. The SEBI Code omits any recommendation of this sort and does not even raise the issue, despite its own clear assertion that 'Till recently, it has been the practice of most of the companies in India to fill the board with representatives of the promoters of the company, and independent directors if chosen were also handpicked thereby ceasing to be independent' (Code, 6.4).

This is one of the most interesting omissions in our code and will surely be looked at in any future review of the guidelines. Third, almost every code recommends the setting up of remuneration committees so that the pay of CEOs and senior management is not self-determined and there is transparency in the policy governing executive pay. SEBI makes this a non-mandatory recommendation, i.e. desirable but not essential, although disclosure of the compensation package *is* mandatory. Again, this looks like a compromise between conflicting pressures.

On the issue of bifurcation of the top post, there is a difference between the US and the UK codes, but the balance clearly favours bifurcation, that is, a separate and independent non-executive chairman. The SEBI Code skirts this issue, i.e. abstains from any specific recommendation, which means effectively that the present set-up of substantial concentrations of power in a single board member, and of shadow directors, is left unquestioned.

On the responsibilities of institutional investors, most codes agree that they should be encouraged to intervene, should exercise their voting rights, and should state their voting policies. For example, according to the UK Combined Code, ‘Institutional shareholders have a responsibility to make considered use of their votes’, while the recommendations of the European Association of Securities Dealers stipulate that ‘Institutional investors acting in a fiduciary capacity for external beneficial owners should state their voting policies’. These are crucially important recommendations for they will determine the whole future course of how proficiently companies are run. Here, as is well known, the draft SEBI Code circulated in the last quarter of 1999 was more concerned with reducing the presence of institutional nominees on Indian boards, although the final version of the code took a more cautious and neutral stance, and suggested that the institutions ‘should appoint nominees on the boards of companies only on a selective basis’ (Code, 7.4). Whatever the drawbacks of the institutional nominee system, the regulator should surely have sought to encourage a better quality of monitoring and concentrated on the issue of how that is best achieved. Indeed, there is not even a recommendation in the code that the institutions should state their voting policies. Contrast the Cadbury recommendation that ‘institutional investors should disclose their policies on the use of voting rights’.
Finally, coming to transparency and disclosure, three areas are particularly important: a) transparency of ownership, b) directors’ interests in transactions or matters affecting the corporation, and c) a substantial discussion of business issues in the form of Management Discussion & Analysis. Of these three areas, two, fortunately, *are* covered by mandatory recommendations in the code, namely, the second and third. Transparency of ownership is, curiously, omitted. By contrast, the code of best practice released in South Korea last year states, ‘Corporations shall disclose detailed information on the share ownership status of controlling shareholders and on persons of special relation to them’, and the European securities dealers recommend that ‘information on the company should at least cover its significant shareholders if known – including cash-flow rights, voting power, diagrams of ownership and control cascades, cross-shareholdings (etc.)’. Lack of transparency is endemic to the way Indian business has been structured, and bringing disclosure up to international standards will require a sustained push from the regulator. A major part of

SEBI's work is being left to the Institute of Chartered Accountants, and it is likely that they are close to finalising an exposure draft on consolidation of accounts. A key issue here is whether a 51% threshold level of consolidation will make a substantial difference in Indian conditions.

Within the existing constraints of liquidity and transparency, international investors may not have much of an incentive to contribute to improving standards of corporate governance in the Indian market. Indeed, it is possible that within those constraints the corporate sector's capacity to absorb international investment may well be close to saturation. Thus the determination to change has to be driven internally and we need to reach international standards of credibility soon, with a well-thought out agenda and uncompromising consistency.

2. Boards: the lack of independent directors

Our interviews began by asking 'How is the board selected?'. It is clear from the responses that whatever the formal process of consultation between the chairman and the promoter, or within the board itself, boards were chiefly selected by promoters. With the exception of institutional nominees, the vast majority of board members are there at the behest of management. What this means is that the majority of outside directors on Indian boards are probably identified on the basis of existing contacts. This has implications for the character of the non-executives who serve on Indian boards, but it also implies that boards are not selected through any formal selection procedures, in particular, the kind of nomination committees that have now become common in the UK, following Cadbury. Only one of the 44 private-sector companies interviewed by us had had a nomination committee in operation for most of the 1990s (ICI). It is therefore odd that the SEBI Code of corporate governance is so reticent about nomination committees, despite the major importance it ascribes to so-called non-executive directors.

Merely having outside people on the board is not enough. It is the process through which they come on the board that is important. According to me, the major flaw was that those people were regarded as having been brought in by the promoters themselves. Therefore they never looked upon themselves as independent directors who had a responsibility not to the promoters but to the outside shareholders. This statement by the former head of one of the country's leading financial institutions shows how widely misconceived the issue of director independence is. In other words, the issue of independence is not primarily one of the number or even the proportion of external directors on the board, but primarily one of their selection and responsibility.

Table 1 shows that numerically there is a predominance of non-executives in most of the larger Indian companies we looked at. Between 65 and 70% of all directors in our sample companies are non-executives. Indeed, in one out of five companies the managing director was the only whole-time director on the board! In a *formal* sense, then, the vast majority of these companies were already in compliance with SEBI's recommendation that 'not less than 50% of the board should comprise non-executive directors' (Code, 6.9). In their discussion of the way boards operate, Demb and Neubauer point out, ‘An all-outside-director board may be objective and detached, but the directors are very vulnerable to either systematic manipulation of information, or simple ignorance, since the board’s only member with solid knowledge of the company is also the board’s chief source of information’.[13] The managing director of a large cement company told us: *I think we don’t have a problem of having too many executive directors in India. In fact, the classical companies which have gone into bigger problems are companies which have no executive directors in them… I would personally recommend that more executive directors should join the board to become responsible for what’s happening.*

On the other hand, though non-executives predominate numerically, the distinct impression from our study is that *independent* directors are rare and that the majority of companies in the Indian private sector do not have independent directors in any meaningful sense. In other words, the majority of non-executives either cannot be construed as independent or choose not to exercise their independence. The first of these suggestions is strongly implied in the following response: *(The term ‘independent director’) is misleading in that it implies that there are directors who are separate and distinct from the promoters of the company, or, if not formally promoters, from those who are actually managing the company, and that they will act for the real interests of the company and if necessary for the small shareholder and against the management. No such director exists in India*. Less sweepingly, when asked ‘How do you see independent directors?’, the head of a global consultancy replied, *There are some excellent independent directors, but not many,* and said it was up to management to decide whether they wished to make effective use of such directors. Throughout the period of our interviews, boards (and directors) were consistently described in terms emphasising their lack of independence,[14] even though in the company interviews ‘eminent’ was the term most frequently used to describe the kind of personality chief executives themselves were keen to have on board. The paradox involved here (in the large number of non-executives coupled with the apparent rarity of truly independent directors) raises a series of questions. Firstly, and most obviously, why do non-executives not seek to influence board decisions in the manner expected of independent directors? Secondly, is the general lack of independence among non-executive directors peculiar to India?

With regard to the first question, the answer has largely to do with the fact that the overwhelming majority of non-executives are either (a) professionals with business transactions with the company (or a related company in the group), (b) retired executives, or (c) currently executive directors of other large firms. A very large number of our respondents were asked how they would define an ‘independent’ director. The following responses are typical:

1. *I define an independent director as one who does not have any business relationship with the company on a continuing basis* (CEO of a software firm);
2. *The definition of an independent director is one who does not have either personal or financial interests in the company, on the board of which he*

participates. (Hence no business relations with that company?) Business or personal, I would say (MNC non-executive chairman);

(3) *Abroad it has been very clearly identified that if someone is a consultant or counsel of the company, he's not an independent director. In other words, if he's getting remuneration from the company of a substantial nature, then he's not an independent director. And unfortunately, we have not recognised that in India* (private equity fund);

(4) *An independent director must not enjoy any relationship of profit with the company. The minute you have a commercial relationship with an organisation you're compromised. So I would say that there should be absolutely no commercial dealings between a director and a company. I'm being very harsh but it has to be that way...in India there is far too much of this sort of commercial interest coming to bear* (Tata director).

Applying this model of independence, it was the consistent impression of our respondents that the large number of professionals who serve on Indian boards could only doubtfully be construed as fully independent or truly independent. For example,

> *(In terms of that definition, is it your impression that the majority of professionals who are on the boards of Indian companies are not actually independent?) They are not independent at all!* (CEO of software firm);
> *(Do most professionals who sit on boards have 'commercial relationships' with those companies?) I would say that the balance is more...there are commercial relationships* (Tata director);
> *I suppose professionals are also tailored to India; when there are professional people on the board they somehow become directly or indirectly related to the transactions of the company* (regulator);
> *My own experience as a corporate lawyer with Crawford Bayley & Co., South Asia's largest and oldest law firm, as well as my own practice, and my short experience as a director, has shown me that these lawyers who are sitting on the boards of companies as well as the chartered accountants, have no other interest other than ensuring that all the legal work of that company comes to their firm. That is their only interest in sitting on the board* (corporate lawyer);
> *You'll have lawyers associated or you'll have accountants associated or you'll have some of the management consultants associated on the board, and on the other hand they earn, in some way or the other, contracts and fees from the company. So there's in a way a kind of self-feeding mechanism there, where you have a high vested interest not to take a critical look at the way companies run* (fund manager).

Thus the first and most pervasive response has to do with the whole issue of the independence of professionals who serve as non-executives. The overwhelming majority of this group would count as 'affiliated non-executives' or 'grey area' directors. The fact that such directors are common elsewhere as well has led some scholars to suggest that regulators might more usefully emphasise disclosure of 'the nature of the relationship (between such directors and the company) rather than dictating specific balance and compositional requirements to the board'.[15]

Secondly, given the lack of nomination committees free of management control, few non-executives 'look upon themselves as independent directors who have a responsibility not to the promoters but to the outside shareholders'. A solicitor who felt that the quality of Indian non-executives was largely 'unsatisfactory' 'because of the way boards are structured and selections are made', also stated *subconsciously always you sort of remain more loyal to the management, no matter how much of a professional you are*. This point about 'closeness' to management can be expressed in a less subjective way by noting that boards in India work on consensus. *It is not the attitude of the board to have open discussions and to allow for discussion* (private equity fund). R. H. Patil has written:

> Often, the expectation appears to be an implicit gentleman's understanding not to raise any serious or inconvenient questions. The institutional nominees often report that no serious discussions take place at the board meetings even on important items concerning the functioning of the company or its investment plans, but very little could be done because in many cases their presence is probably just tolerated.[16]

The chairman of the one large private-sector company that did have a properly functioning nomination committee (called the Remuneration & Nomination Committee, or R&N for short) felt that *the concept of "independent director" is very new (in India). And therefore there was a great deal of comfort by getting professionals who would provide professional advice but not necessarily professional challenge. That is the distinction. A professional who is both qualified as well as friendly is a more comfortable professional than one who is professional but not necessarily friendly. And therefore boards were a mixture of both comfort and competence*.

The distinction between 'advice' and 'challenge' raises a more fundamental issue about the tensions inherent in a unitary board structure which we shall come to in a moment. It seems clear, for the moment, that non-executives work within a boardroom culture shaped by traditions of deference and management control of boards, and these are likely to act as serious impediments to the performance of any monitoring role they might be expected to play, even supposing they were free of all 'commercial relationships'.
A third and crucially important factor which, surprisingly, receives no mention in the SEBI Code is the time constraint. This was mentioned repeatedly by both top management and non-executives, and must surely account for a large part of the story about lack of contribution. Here are some revealing responses:

> *Most of the boards in the large business sector have people from diverse walks of life, and the contribution which has been made by them is not commensurate with the time that they spend at the board meeting.. Let me re-phrase that: what happens is that people do not devote adequate time to understand the agenda papers, understand what the business of the company is at that particular point in time, and what needs to be done to the business. They just pick up loose ends based on the discussion that*

> *takes place at the board meeting, and make a contribution…They do not have enough time, frankly, let's face it. They should be bold enough to stand up and say, "I don't have the time, I'll not be able to make any contribution"; but people don't want to do that; they want to meet the 'magical figure of 20'* (auditor);
> *Professionals or outsiders are very busy in their own right and they have their own agendas to pursue. The result of which (is that) the kind of attention and time that they can devote to boards - and particularly when you're involved in multiple boards - is very very limited* (solicitor).

From the executive side:

> *We share this with the external directors, we share with them our perspective of the business. But it is rather meaningless to have…today each external director that we have has 20 other directorships, he can't do justice to anything. I mean half the time he's looking at his watch to find out how quickly he can go off to the next meeting. And rather than us not wanting them, we have to cajole them to come and spend time with us!* (MNC executive);

> *Well, you see the same name popping up on ten boards. Now if you assume, for example, that a good director needs 20 days to contribute to a company's working, that's 200 days. I mean, if he's an executive of a company, what's he doing? Managing a company or being a director on the board?* (industrialist).

Lack of high-quality professional/non-executive time may reflect the deeper problem of a scarcity of suitably qualified independent directors, and several respondents did say they thought this was a major problem.[17] With the SEBI Code now mandating specific numbers and proportions of non-executive directors, in the long run managements will presumably have to shift their focus from existing contacts to executive search. However, it is also possible that the problem of an adequate supply is currently exacerbated by the particular model of corporate governance which Indian professional and professionalising managements now largely subscribe to, namely, of the desire to have external directors who can 'add value' to the board and contribute to value-addition by the board. The chairman of one of the country's most admired corporations stated, *When we decide to select the external directors, we say that these people will have to add value in a specific functional area* (e.g., someone who has done mergers & acquisitions and created a good strategy framework for a multinational, or someone who can head the audit committee)..*The function of the board is to bring value-addition at the highest levels of abstraction in their chosen areas of functional specificity*. This upgrades and generalises the 'advice' function that professional non-executives have traditionally been hired to perform (with obvious ambiguity in the role such directors see themselves playing), and makes the supply of independent directors contingent on the managerial and professional labour markets. Whether there is sufficient expertise for most of the larger companies to revamp boards on the value-added model remains unclear.

Fourthly, top management is clearly under no illusion about its ability to circumscribe the real effectiveness of independent directors, with the possible exception of institutional nominees. As the chairman of a powerful management team put it, *what can an independent director do? He would comment on what is brought to him, and that is where, at the heart of the issue, is the ethics and integrity inherent within a corporation – because otherwise you can comment on what is there for you to see.* For Indian-controlled businesses, the point was put in the following way by the controlling shareholder of a cement company: *At the end of the day, you may have a good composition of certain boards, but if the entrepreneur doesn't wish to listen to them, there's very little the outside members of the board can do except make a few suggestions*. It is clear from these statements that non-executives, obviously even those who are formally independent, simply work within a framework defined by management. This, of course, is not just an issue of what is brought before the board and what is not, but of the whole organisation of top management, which is such, in all the larger companies, that by and large, even if there *are* companies with relatively strong boards (for example, Tata Steel, ICI, and BSES, among our sample companies), boards are really driven by management. Interviews reveal that in the larger firms the executive directors form a separate team which usually includes the various functional heads, meets weekly or fortnightly, and describes itself variously as 'management group', 'management committee', 'management council', or 'executive committee'. The point is not, of course, that boards are dominated by this team, but that much of what the board should be doing in terms of supervising and controlling management is done at this level, by management itself. It is clear that if boards are, as one director put it, 'drawn more and more into the area of strategy', it will only be because senior management has decided to have it that way.

The Indian corporate sector has had to live with a tradition of boards shaped by a culture of deference and promoter domination over companies. But to these important aspects we should add a third which is much less obvious, namely, the tension inherent in the unitary board between the management and governance functions of non-executive board members. The most serious criticism levelled at Cadbury was that it failed to address the 'inherent conflict of interest caused by non-executive directors being both an integral part of the management team and also monitors of their executive colleagues on the board'.[18] 'It is difficult to see how NEDs, organised as the opposition in a bifurcated board, can both contribute positively to the leadership of the company and act as monitors of the performance of directors including themselves'.[19] If this is a credible argument, it would explain why there is in fact so little clarity on the role of the board of directors, particularly in India. In the Cadbury scheme of things, a key function of the three subcommittees at board level is to strengthen the influence and independence of non-executives so that their control function is more clearly defined, but as far as the UK is concerned, it is clear from the recent consultation document of the Company Law Reform Steering Group that the monitoring role of the NEDs is still largely an undeveloped area.[20]

To sum up, there is probably considerable variation in the quality of individual boards but in general few, if any, truly independent directors, largely because most non-executives would fail to qualify on the standard tests of independence.[21] SEBI's compositional stipulations are unlikely to have much effect unless managements decide that a strong board is essential to the strategic capabilities of the company and important to its corporate image. This is largely the same as saying that 'Voluntary codes mean nothing unless they change corporate culture'.[22]

Nominee directors

A careful survey of the press would show that since September 1996 there has been a great deal of institutional pressure for reform of the governance culture of Indian businesses. That was when the financial institutions first mooted the idea of a block sale of their equity holdings to effect a management change 'if it is in the interests of the company'.[23] This extremely radical idea failed to get off the ground for a variety of reasons which include a strong business lobby backlash that has chosen to make the issue of institutional nominees central to the debate on governance. Since SEBI allowed itself to be directly embroiled in this controversy, oblivious of any conflict of interest, we shall comment later on these portions of the Birla Committee report. Although contributions to this debate have ranged from the hysterical to the more considered and dispassionately argued, almost no attempt has been made to disentangle the different issues involved. Some of the distinct issues are: (a) do institutional shareholders have a right to be represented on boards? (b) should institutional shareholders seek board representation? (c) is the present nominee director system the most effective and efficient means of institutional board representation? And finally, (d) does insider trading have any relevance to issues (a) and (b)? (a) and (b) are clearly different issues; the fact that shareholders may have a right to be on the board doesn't necessarily mean that they will want to, or see it as in their best interests to, exercise that right.[24] Moreover, there are different kinds of institutional investors and the strategic issue under (b) may have different kinds of resolution depending on the kind of institution involved.[25] We shall return to some of this later and concentrate for the moment on nominee directors.

The presence of institutional nominees is certainly the most distinctive feature of the Indian corporate governance system, and consequently the 'failure' of corporate governance in India is often seen as a failure of the institutions to safeguard the general shareholder and public interest. And of course, no feature of India's corporate governance has generated more controversy. Among the large number of business representatives we spoke to there was a clear division of views on the issue of nominee directors, with widespread hostility among corporates but strong support among professionals and a few managements as well. The more critical responses consistently emphasised lack of contribution, occasionally also the low calibre of many nominees and their lack of competence in understanding the business. Respondents who were more sympathetic to the role played by nominees also evaluated that role in rather different terms, emphasising not their ability to contribute so much as the restraint imposed on managements by the presence of nominee directors. Several managements were extremely positive about the contribution of their institutional directors. Finally, the few nominees we spoke to emphasised the severe constraints within which they operated but, interestingly, interpreted these rather differently. The following excerpts from our interviews illustrate these diverse points of view.

Lack of contribution was the most common complaint:

> *I have in the last three years sat on so many boards, along with institutional nominees, and I don't think they take a stand or they speak up or do something like that. (That) is an idealised image of the institutional nominee director* (non-executive director);
> *Where there are representatives of the Indian development banks, which is in almost every company, board meetings that I've attended, when there's some kind of financial transaction to be done, they don't contribute at all* (investment banker);
> *at our board meetings the institutional shareholders hardly open their mouth* (industrialist);
> *For myself, over my eighteen year span, I would argue strongly that they don't contribute. There may be exceptions…*(Tata director);
> *(What is your own experience of the kind of contribution that nominee directors make?) Very poor! (But why do you feel that is?) Number one, because they don't have any sense of responsibility or accountability, they have no stake, no professional stake in their role, and they feel it's just another job to be done* (MNC non-executive chairman);
> *(What about the nominees? How do you see their role?) I think there is no role that they have played at all. I don't see any purpose of these institutional directors. (But are you generalising from your own experience?) I am generalising from my own experience as well as all the other companies* (industrialist).

Lack of the requisite skills in dealing with businesses:

> *You often go to companies where they have institutional nominees, they don't even have a clue about what the business is all about!* (head of investment banking division);
> *Even the kind of directors we have do not have that kind of competence that they can really understand the balance sheets or understand the game. Their personal contribution cannot be substantial* (institutional nominee).[26]

Professionals who serve as non-executives were more supportive:

> *The financial institutions have their own cell, and they are in a better position to elicit more from the management rather than non-working directors like us, who merely attend board meetings … I'm on quite a few good companies, where high-level executives are representatives of financial institutions. And they are quite vigilant* (solicitor);
>
> *Even participation by institutional directors quite often acts as a very wholesome safeguard of the interest of the minority shareholders, as long as institutional directors are sincere, and not under the obligation and shadow of the Indian promoter; they can also act as a very important check against any abuses* (solicitor).

The nominees themselves do not necessarily view their situation in exactly the same way. Two nominees who spoke with a degree of frankness expressed very different points of view. The older of the two, quoted above, complained of the hostility and isolation which such directors face: *Ultimately, an institutional nominee or director is not a welcome constituent on the board…You are a lonely voice, you are not there to create unpleasantness.* In contrast, a young ICICI manager thought the major issue was one of time and incentives:

> *Now I'm a nominee, many of my colleagues are. How much time do we have? It's not our main job…I am in the position of an independent non-executive director. What incentive do I have? Why must I challenge executive management? ..The question is that of time. I'm not a full-time board member, I'm a full-time employee somewhere else. Sitting fees are two thousand rupees…How much can you pay? My time is worth, to my company, in lakhs. That is the value of my time to the company. Who is going to pay me that much money?…The compensation would have to be really large to get a truly competent guy.*

The fact that a lot of our interviewees were critical of the nominee director system does not mean that these respondents were necessarily opposed to seeing institutional nominees on boards. Many felt there was no point in having institutional nominees if they were not going to be effective, and that nominees were there essentially to play a proactive role:

> *I think the institutions should, if they do nominate somebody, have a far more proactive role in understanding the business* (head of investment banking division);
> *A nominee director has a very important role to play. In fact, right under their noses things are happening!* (private equity fund);
>
> *They (the institutions) are largely reactive. What I would like to see is the institutions getting very proactive, and, if that happens, my God, things will change! Change very rapidly..*(fund manager).

The underlying issues are much larger ones, of course. For nominee directors to play a more 'proactive' role the whole culture of the boardroom has to change. Institutional heads have repeatedly complained that 'FI nominees on boards have little powers as they are only updated on those matters of the company which are placed before the board'.27 Secondly, with institutional governance policy largely driven by the government, it can always be argued that it was primarily up to the latter to enforce stricter standards of supervision. This change has only begun to come about in the last few years, under the pressure of global integration, the collapse of the primary market and rising NPAs. Finally, there is the whole issue of whether the institutions should continue to depend on their own resources or outsource expertise. Data collected by us in the course of this research shows the staggering scale on which the public financial institutions have had to conduct monitoring. As of end-1999 IDBI, we were reliably informed, had 470 nominees spread over 1026 companies, of which the majority, 364 nominees, were officials of the institution. In the same year, LIC had 124 nominee directors sitting on the boards of 171 companies. Half of these nominees were retired employees of the company. In ICICI, as of March 2000, there were 231 nominees supervising a total of 436 companies, with 98 executives/officers and 133 outsiders. There is also strong evidence to suggest that the institutions have been debating a more viable threshold limit for the deployment of nominees.

Audit committees

All codes of corporate governance recommend the establishment of audit committees but few jurisdictions have so far actually made them legally mandatory. Canada and Singapore are exceptions in this respect. By law Canadian public companies are generally required to have an audit committee of at least three members, the majority of whom must be independent.[28] Similarly, the Singapore Companies Act sets out basic requirements in relation to the composition, duties and responsibilities of audit committees.[29] However, in most markets the listing rules of the stock exchange require companies to disclose compliance with a code of best practices, which includes having an audit committee. In India, audit committees are now required by both statute and the listing requirements. SEBI's recommendation involves the setting up of audit committees composed only of non-executive directors, of whom the majority are 'independent'. The interesting issue here is whether SEBI's definition of 'independent' is sufficiently tight to make the compositional requirement at all meaningful. It may also be helpful to note at this stage that though the publicly stated aims of the audit committee are to help ensure a high quality of financial reporting, to increase the credibility of audited financial statements, and to protect auditor independence, the academic discussion of their effectiveness has been described as 'limited and inconclusive'.[30]

While audit committees are not widespread among the larger companies, they have made some headway in the 1990s. Table 2 shows that out of 37 companies listed, 11 reported having no audit committee at the time of the interview. The largest number - 16 - reported having set one up at some stage in the 1990s, most of them, in fact, since 1996. In contrast, there was a handful of longer established companies which said they had had an audit committee since the eighties. These included Tata Steel, Rallis, Mahindra & Mahindra, Voltas, Larsen & Toubro, Nocil, and ICI. With the exception of ICI, none of the foreign subsidiaries could report having an audit committee since the eighties. In fact, it is of considerable interest to note that 75% of this limited sample of MNCs would not have had an audit committee till as recently as 1998, and that 5 did not have one at the time of the interviews. On the other hand, these are clearly companies with professional managements, tight control by their parent companies and regular visits from their global audit teams. Among Indian businesses, the most interesting case was Gujarat Ambuja, which said that they had had an audit committee 'from the very beginning', that is, since 1986.

These results certainly suggest that audit committees are likely to become widespread in the next few years. The issue is not whether such committees will exist but how they will function and how effective they will be. Audit committees are designed to reinforce the position of independent directors and be a demonstration of their independence.

Consequently, under the new audit committee rules in the US, both the NASD and the NYSE now require an audit committee to consist of at least three independent directors who are financially literate, with at least one member having accounting or related financial sophistication or expertise.[31] Moreover, both the NYSE and NASD have enhanced their definitions of “independence”. Unlike SEBI, which confines the lack of independence to ‘pecuniary relationships or transactions’ (Code 6.5), NASD disqualifies as independent a director who is “a member of the immediate family of an individual who is, or has been in any of the past three years, employed by the corporation or any of its affiliates as an executive officer”.[32] Under the definition of independence recently endorsed by the Association of British Insurers (ABI) and National Association of Pension Funds (NAPF) in the UK, a non-executive director fails to count as independent if he/she was once an executive, or if he/she has been a non-executive director for nine years, or if he/she is closely related to an executive director.[33] Clearly, none of these situations would be covered by the definition proposed in the SEBI Code. Almost all the auditors we interviewed felt that audit committees should be both mandatory and independent. For example:

> *they should be made mandatory, and there should be proper guidelines as to how audit committees are constituted..the important thing is that no one from the management should be a member of the audit committee. In fact, even in the case of banks now we have recommended, the RBI has recommended, that the chairman of the audit committee should be a non-executive director of the bank* (leading accountant).

Audit firms that service a smaller size of client may well be dealing with committees dominated by management. In one firm of this sort we were told:

> *In audit committees the meetings are chaired, still, either by the chairman of the company or managing director of the company. Fortunately, in a couple of companies where I am internal auditor, they are not fully owner group, but again, as I’ve said, indirectly somehow that influence is there* (accountant).

In fact, a surprisingly large number of firms which did report having an audit committee stated that their committee consisted entirely of outsiders or non-executive directors or ‘independent’ directors. These, by implication, were all committees chaired by an outside or non-executive director, and some of these committees were described as functioning extremely well. A non-executive member of the HDFC audit committee stated, *We find that the kind of work which we are able to do is phenomenal. Everything gets reported*. In one company where the audit committee was said to be ‘very powerful’ (Voltas), the written response stated, ‘the Committee meets at least once in two months’. Auditors placed a great deal of emphasis on the composition of audit committees and on the chairperson being an independent, professional director. In terms of international best practice the relevant issue is that of the independence of the non-executives who are otherwise, clearly, fairly widespread on such committees. For example, in one MNC that set up its audit committee a few years ago, the committee was said to include the Regional

Managing Director, a non-executive who was also one of the parent's two nominees on the board. In another case, involving a large business house's flagship company, the committee comprises three non-executives, of whom one is a former chief executive of the company and the second a nominee of the company's UK partner. Thus if independence is the crucial feature of the audit committee, it is not sufficient to say simply that the committee consists entirely of non-executives.

About codes of corporate governance in general, it has been said that 'it is in the nature of voluntary arrangements of this kind that those whose behaviour is most in need of reform are the least likely to comply'.[34] If compliance is understood here in the substantive sense of compliance with the spirit of the recommendations, then that statement is probably particularly true of audit committees. One of our most interesting auditor respondents noted:

> *In the kind of companies that I deal with, wherever they obtain, they work beautifully.. but I'm not sure how it operates in practice outside my limited world. My interaction with other chartered accountants who have spoken confidentially is that it operates in a very negative way. I will tell you how..(the way it operates) is that (the committee members) are guinea pig directors who have held very high positions of eminence in other walks of life.. three or four real heavies. They come.. The people who really control the business do not appear. You go with a list of points, and it is four of these outsiders, some of whom may have held very high positions in other walks of life. There are commensurate egos, they start off by saying, I was so and so at that time, you know, you knock this out, or, more simply, let us see, next year you raise this point, this year let it go. So therefore you're talking to a set of people who are not talking the same language at all, who are very senior. They come charged with the responsibility by the man who in fact wants to knock down all the audit find and they'll do his hatchet job for him. That is, the auditor then goes, and here are four men who are otherwise languishing in retirement or really, for some reason or the other, would like to keep in the good books of the people. It is very difficult to convince them as to the needs and obligations of credible financial statements as understood in the western world today.*

This was an extremely revealing response, as it illustrates the major hazard with 'applying' a code of corporate governance in a mechanical way that fails to grapple with the larger issues of why there is no culture of compliance, why regulations have so often failed, and whether codes can overcome the shortcomings of the regulatory environment. At the time the draft Companies Bill, 1997 was being debated, one company secretary who pleaded strongly for the exclusion of management representatives from the audit committee did note the possibility that even with a seemingly proper composition, 'Some company managements may use such a committee to camouflage their misdeeds'.[35] Clearly, the majority of promoters are likely to feel uncomfortable at the prospect of truly independent directors having access to their company secretary or chief financial officer or chief internal auditor without any executive directors being present at the meeting of the audit committee.

3. Disclosure and Accounting Issues

The quality of financial reporting is a function of both accounting practices and disclosure standards, and reporting is strongly driven by the markets, insofar as institutional investors, especially FIIs, place a premium on transparency. In India the level of disclosure is abysmal and creative accounting rampant. This clearly is an area where the key role is that of regulation, even if *voluntary* disclosure sends powerful signals to the market, and a key issue relates to the harmonisation of Indian accounting standards with US GAAP or IAS. We asked interviewees what additional disclosures they felt were required and which provisions of US GAAP they thought were most needed. In general, auditors were more forthcoming on these issues than corporates. There was a general feeling among all respondents that what mattered was not the quantity of disclosure but its quality and relevance, including the need to revamp the directors' report to become a more substantial discussion of business issues. On international and Indian GAAP, the responses showed a high degree of consistency. Most interestingly, there was strong support for consolidation of accounts (an accounting issue), but much less enthusiasm (among corporates) for segmental information (a disclosure issue). Related party transactions figured prominently in the auditors' responses as a major area of 'further embellishment'. Finally, while the quality of auditing in a 'straightfoward ticking sense' is perceived to be high, the flexibility of accounting standards undermines the credibility of many audited financial statements. Moreover, qualifications do not lead to corrective action, further compromising the perceived powerlessness of auditors in the face of corporate pressure. Auditor independence is a problem worldwide but especially so in India where there is a large if segmented market in accounting services.

Table 3 shows that consolidation of accounts was perceived to be the most urgent priority in the interviews conducted with the accountancy profession. Ten out of fifteen auditors mentioned consolidation in advance of any other provision of international GAAP. Indeed, the discussions instigated considerable commentary on the issue, because the fact that the Indian Companies Act, 1956 chose not to make consolidation of accounts mandatory was symptomatic of the decision to allow a certain form of business culture to thrive. Regulation *allowed* for the extraction of substantial 'private' benefits from control,[36] while, on the other hand, Indian promoters were *able* to exercise direct control over companies even in the absence of concentrated ownership (contrast France and Germany), through the use of investment companies, cross-holdings and control of management.[37] One implication of this form of corporate culture was rampant clandestinity and the general obliteration of the rights of minority shareholders and other stakeholders. The nineties have begun to change all this by integrating the Indian corporate system into a larger framework where the parochial traditions of local business élites are more or less rapidly disintegrating under the manifold pressures of global integration. The widespread demand for consolidation of accounts is brilliantly illustrative of this transition.
Some chartered accountants have argued that despite the absence of consolidation, Indian financial statements give enough information for analysts to reconstruct the true picture of

a group of companies. However, for most users of financial statements, the absence of consolidation was generally seen as 'very misrepresentative of the true picture of a group':

> *If you look at some of the larger group companies, the large family-owned (businesses)… you get absolutely no idea of what actually is happening overall* (MNC executive);
>
> *A consolidated report for statutory purposes can be at least a beginning, so that the regulatory authorities have access to consolidated information of large, heterogeneous groups with multiple portfolios. I think it's a mine field that somebody has to unravel* (MNC non-executive);
>
> *I think the accounts as they are presented today really hide a lot. If you were able to consolidate a group and look at it as one entity, that would really ease things up a lot* (MNC finance director);
>
> *a lot of things are hidden away, quite obviously. You have a distorted picture to the extent that you do not consolidate* (Tata CEO);
>
> *(Consolidation of accounts?) I certainly think it would present a truer picture and I urge the government to do something about it as quickly as possible. Because that is another subterfuge which is used to hide all sorts of sins* (MNC executive).

In the UK companies use 'quasi-subsidiaries' to avoid consolidation without technically infringing the letter of the law. Indeed, 'In recent years creative compliance in the form of the "quasi-subsidiary" has underpinned "the most commonly used and well-known" OBSF transactions'.[38] A major motivation here is that liabilities are hidden from the reader of accounts. But wholesale lack of consolidation will clearly have a similar function:

> *Losses parked in subsidiaries, which today do not get fully reflected, will come into the consolidated accounts* (accountant);
>
> *Very often you can have huge loans being issued to subsidiaries shown very innocently in the parent company's balance sheet. And those loans have all gone to subsidise huge losses within a subsidiary company* (MNC executive);
>
> *I think all these companies have been created through adding on a lot of debt, and the debt actually lies all over the place, and if you consolidated it all, you'd probably be able to see the true liabilities of these companies..(You mean they are much more leveraged as businesses than they appear to be?) I think so, yes, a huge amount of leverage, especially through their finance arms, etc. Why do a lot of groups have finance arms? Probably, it's because you can have a debt:equity of 10:1, in those companies, as against a maximum of 2:1 or 3:1 in a normal manufacturing outfit* (MNC finance director).

It is difficult to gauge the true extent of opposition to the mandatory introduction of consolidated accounts. On the one hand, Table 2 shows that among our sample company respondents there was a high degree of support for consolidation, with 7 out of the 12 MNCs averring 'strong support' (in the authors' assessment), and 15 Indian companies expressing some degree of support, from statements that the company would be consolidating its accounts in the near future (Reliance, BSES) or, indeed, had done so (Infosys) to clear endorsement of the need for consolidation. At least one management (Crompton Greaves) claimed that in their case it would lead to a stronger balance sheet. The major objection expressed was that the Indian tax situation rules out consolidated accounts. A well-known industrialist argued:

> *consolidation would work if they also consolidated the tax. I'm in favour of consolidation myself. See, what happens today is that in our balance sheet, you will see, every subsidiary's accounts are there. What is not there are non-subsidiaries. Now if you say consolidation should be only 51%, it's all there, except it's not all put together. But if anybody wants to read it, it's all there. That is required by law. But I think the problem of consolidation this government hasn't faced up to right now, and we say to them, well, then you've got to consolidate your taxation structure…you can't have it both ways, which they are not willing to do.*

We were also told that when the issue was discussed by the Working Group on the Companies Act, 'there were representatives who didn't feel so enthusiastically about it'. Investment companies are a major vehicle for the extraction of private benefits and a major reason why many business groups may not want consolidation.

> *The reason why consolidation was opposed was precisely this reason. And it was opposed by people who were let's say closest to the Indian business houses. (When you say, 'precisely for this reason', because it would put an end to investment companies?) Yes. It would expose very clearly.*

A second possible source of resistance could be the likely impact on the size of various groups:

> *(Isn't there a general consensus in favour of consolidation?) I don't think there is. I think that in a lot of the family groups they very much fear that if you consolidated, the size would be diminished very substantially indeed. But we don't know what the truth of it is, we can't find out* (investment banker).

Two substantial issues relating to the introduction of consolidated accounts are whether 51% is an appropriate or relevant threshold for consolidation, given that 'there are not too many subsidiary companies in Indian companies which are material', that is, not established purely for 'investment' purposes, as a leading accountant noted. And secondly, the related issue of how 'control' is to be defined in the Indian context where promoters have traditionally worked through 'complex chains of control'. As a senior partner of PricewaterhouseCoopers told the press: 'In India a lot of the control is indirect, exercised through trusts and religious charities...*In India it would be very difficult to establish what constitutes control'*.[39]

The Bhave Committee had made consolidation of accounts, segment reporting, and deferred tax accounting key recommendations of its report in 1997, arguing that these were international best practice. Of course, none of these have been implemented to date. On segment reporting, the dominant response among our interviewee companies was the fear of disclosing competitive information. For example, even in one of the most professionally run companies the response was:

> *(Would you be willing to disclose your profitability by business segment?) The answer's very simple, we don't have a problem disclosing it business-wise. We don't do it today. And the reason we don't do it is that under Indian law it's not required. And we'd be very happy to do it if competition did it as well. But we don't want to be a sitting duck for competition having information which we may not* (MNC executive).

In fact, in the UK exemption is allowed if the disclosure 'would be seriously prejudicial to the interests of the company', but 'few companies choose to take advantage of this exemption'.[40] The major practical issue relates to the definition of a 'segment'. SSAP 25 concludes, 'determination of an entity's classes of business must depend on the judgement of the directors'.[41] Among our respondents, the most useful piece of commentary came from the finance director of a lubricants major, and it may be worth quoting this in full:

> *You can define business segments in three ways. In the UK they define it by geography and by product group. In the US they say you can define it by a particular group of customers also. In fact, in the US the definition is much broader, it is the way that management looks at the business which is considered a segment. So under US GAAP, as they call it, if the management reviews the business in a particular way, that would be defined as a business segment… If we were asked to do segment reporting under US GAAP, the position would be fairly clear: it's the way the management looks at its business, and therefore we'd have a commercial business, a consumer business, an industrial business, and a marine business, and we'd report sales and profit separately for those businesses, and therefore you could calculate the profitability and the shareholders would get a better idea of how the business is performing. But if you look at it from a UK GAAP point of view, then they look at product and geography, so they really divide it up and say what markets you sell in. US GAAP also requires that, but what markets you sell in and what products you sell. So if you look at Burmah Castrol, they would probably divide it by markets and customers. It doesn't stop companies from disclosing both, what I'm saying is what is the requirement under different financial accounting standards. (But currently is there any segmentation in your own reporting?) We don't report it, no. (This is something the Bhave committee also recommended and it's been taken up in the SEBI Code, so I think it may be coming here) Yes, but I think their segment reporting will be along product and geographic lines. Because what actually the accounting*

> *standards try and do is try and identify risks associated with particular businesses. So if you have a large part of your income coming from, say, a particular territory, then the currency risk etc. attached to that territory, and those sales and profits, can be identified, if you have it. And similarly, if you have a large (part of income) coming from a particular product line, this is then identified. So it's disclosure in that angle. But if you have a company like ours which has a very small export business, and therefore not much comes in it, comes from other countries, then we don't have that sort of disclosure requirement. And then if you say that you're looking at it from a product point of view, then the commercial product and the consumer product would probably be the same. It's only that the customer group is very different..So really it's the way you look at it, and how the Bhave Committee defines it is what's going to be important. Because if they say product and markets, then I don't know whether we'll be required to make any segment-wise…a company like ours and most MNCs, because Indian companies don't sell outside and most MNCs are focused on probably one product line, if you take Glaxo or P&G or us. On the other hand, Levers etc. obviously would have more product lines, because they have their beverages business and their personal products*

Thirdly, a great deal of emphasis was placed by some of our respondents on the need to treat related party transactions as an *accounting* issue and seek stronger disclosures in this field. Indeed, one accountant claimed that *related party reporting is an area where in our GAAP there's virtually nothing*. The head of a company much acclaimed for its own standards of disclosure referred to the 'nexus' between certain companies and their 'non-independent outside directors', based, as he described it, on 'transactions which don't see the light of the day'. He stated:

> *In terms of related party transactions, in fact that's a big problem in the country. It's very easy for a listed company to have many private limited companies in which each one of us has interests, and then conduct transactions at inflated prices, so that they make huge profits and this company is not making any profits. (Is that fairly widespread in Indian business?) There are very many cases, I don't want to talk about specific cases. You know, if you were to take the top twenty companies, perhaps it's not widespread. If you go below that, I would say it's much higher, much higher.*

One respondent felt that non-executive directors should look, or be required to look, more closely into the genuineness of these transactions:

> *The area of greatest conflict of interest is related-party transactions.. That's an area which certainly needs much firmer handling in the corporate governance aspect - the transactions which are normally done at the year end, with the associated companies, which possibly are with a view to achieve the predetermined figure of profit.. The board should be able to put its foot down and say, "No, we will not permit such a transaction to go through"* (accountant).

Again, the issue here is one of definition. According to a leading member of the profession:

> *The difficulty of course is the definition of "related party". In India we've always had this problem, even to define a "group" has been very difficult, and you have used the definition for different purposes. For example, when I was chairing the committee on disclosures in offer documents, we decided that for the purpose of offer in that offer document, we should give a definition of a group because we wanted disclosures to be made. And we made very clear that that definition was only intended for that purpose and no other purpose.*[42]

4. Institutional investors

Unlike the UK, where the dominant institutional shareholder is an arm's-length investor, in India the domestic financial institutions have always regarded themselves as 'committed' shareholders.[43] With large, illiquid stakes in many companies the institutions are locked into their investments and, consequently, the *potential* for institutional monitoring is distinctly greater than it is in the few markets dominated by arm's-length investors.[44] Press accounts also suggest that there has been a noticeable increase in institutional interventions in the last two years. On the other hand, there is a powerful business lobby which seeks to restrain the extent of institutional intervention. The clearest formal expression of this lobby was the CII's Code of Corporate Governance, which was only finally published in 1998. Both the CII and the SEBI Codes claim descent from Cadbury, but it is worth noting that their stances on the rights of institutional shareholders depart significantly from Cadbury's. Indeed, while in the UK the ISC's *Statement of Best Practice on the Role and Duties of Directors* 'had a strong influence on the report of the Cadbury Committee' which provided an 'express endorsement of the ISC code',[45] the CII, it is well known, sought to circumscribe the rights of institutional investors, and the Kumar Mangalam Birla Committee failed to include even a single representative of any major financial institution.

The failure of the CII Code to gain wider acceptability may well have prompted the regulator to step in and fill the void. The author of the draft on which the code is based stated at a CII roadshow that he was 'pained' by the lack of response to the code.[46] Though the CII Code is littered with illogicalities, clearly this is not the place to go into them. But taking its own cue from the Confederation, in its draft form the SEBI Code came out with a controversial suggestion that 'the financial institutions maintain an arm's length relationship with the company *by not seeking a seat on the board of a company*' and suggested they would serve the cause of shareholders better by a use of their voting power at the General Body meetings. (Draft Code, 5.11) This was later retracted in the final form of the code where it is merely suggested that 'the institutions should appoint nominees on the boards of companies *only on a selective basis* where such appointment is pursuant to a right under loan agreements or where such appointment is considered necessary to protect the interest of the institution' (Code, 7.3), and that where institutional directors sit on boards, the nominating institutions should ensure that effective safeguards

exist to control the flow of price-sensitive information. SEBI abandoned its earlier stance largely under institutional pressure, agreeing to leave the matter to their discretion.
The new element in SEBI's suggestion, conspicuously missing in the CII Code, is the reference to insider trading. Had the authors of the CII Code perceived this as a major risk, there is scarcely any doubt that it would have figured prominently in their arguments. Our own scrutiny of the press suggests that the insider trading argument first surfaced in the middle of 1999, in an editorial reacting to the CII's demand for evacuation of boards by nominees.[47] Be that as it may, our interviews show that the argument about price sensitive information has had a considerable impact and is now widely accepted as the stock argument against institutional nominees. It is equally important to realise, however, that the *weight* one assigns to this argument is a matter of individual opinion, and that several respondents proposed persuasive counter-arguments. Following the publication of the SEBI draft code at the end of September, most respondents we interviewed between October and January were asked, 'How do you react to SEBI's draft recommendation that the investment institutions withdraw their representatives from the boards of companies on the grounds that they are privy to price-sensitive information?' It would be useful to disentangle the various arguments on both sides of this important divide.

The arguments against representation took three major forms:

(a) Nominees are privy to price-sensitive information and risk making their institutions insiders; Chinese Walls are a myth;[48]
(b) Term-lending institutions should not seek representation except in the case of an actual or potential default;
(c) There is an inherent ambiguity in the role of the institutional director which might involve a conflict of interest.
The counter-arguments were:
(a) As major shareholders institutions have a right to board representation; opposition to nominee directors is an infringement of their rights as shareholders and produces different classes of shareholders, some more privileged than others;
(b) Insider trading is more rampant among promoters;
(c) The insider trading issue is irrelevant to the question of the rights of institutional shareholders;
(d) Chinese Walls *are* in place in the investment institutions, ensuring that nominees are insulated from the fund management side;
(e) For creditors, the point of having a financial monitor is lost if the company reaches a state where it risks defaulting on its loans.

Some of the more interesting responses were as follows:

> *I believe very strongly that if you are a director, you* *have* *to be aware of price-sensitive information. And representatives of the institutions have to send periodical reports to the institutions. And how can they not report such price-sensitive information back to the nominating institution? So, if an institution is actively trading in the shares of a company, it would be wise for them* *not* *to put people on the*

> *board… I think the institutions which actively trade in the stock market are taking an unnecessary risk in nominating their representatives on the boards of companies. (Of course, they claim that they have Chinese walls in the organisation…) They don't have Chinese walls! No way, no way!* (non-executive director);
>
> *I do feel that entities, whether they're institutions or otherwise, who regularly trade in securities and will have access to special information, should not have nominees. (For example, the UTI should not have any nominees on the board? Is that what you're saying?) Or there should be some sort of a 'Cease & desist', that whatever information comes to them cannot be used as the basis for trading. I'm sure some way or the other it gets used. They should not then trade in the securities of those companies, but that defeats the whole purpose for an institution like UTI… they are on the boards of a whole lot of companies whose shares they are buying and selling every day. Now they make this distinction between fund managers and people who are actually on the board. I don't know how far that really holds up, eventually. If you want to really test it, test it with a hardnose lawyer's approach, I think it'll just break down somewhere. You'll find that the top four or five people know everything. And the top four or five people are involved in the decision-making on what to buy and sell. I know from my experience that every major restructuring proposal that happens in India, the moment your thinking process is over, the first thing that you do is you go and talk to the IDBI, ICICI, and UTIs of the world and tell them that you're going to come up with this two week letter and please bless this. Now that information is provided to the institutions, but from that date onwards, till the proposal actually gets announced trading goes on merrily…it's very illustrative of the kind of special knowledge which institutions in the Indian environment (enjoy). They are far more powerful than similar institutions anywhere else* (lawyer, on several corporate boards);
>
> *Why should they have a right to be on the board? (Well, as dominant shareholders?) Even in the United States, CalPERS doesn't have seats on any board - none of the financial institutions. Because you have a huge conflict of interest, you are privy to a lot of information which the ordinary shareholder isn't. And if you've got arms of those companies which are trading left, right, and centre, huge…(So you think this does happen, despite all the Chinese Walls?) This Chinese Wall is a figment of people's imagination. I tell this to my investment banking friends from Goldman Sachs and Merrill Lynch and CSF - don't give me all this rubbish about the Chinese Wall* (Tata director).

McVea notes that the 'crucial question surrounding the Wall is the extent to which it can be "straddled" by top executives', but adds, 'To what extent this is a problem is uncertain and much will depend on the exact circumstances'.[49] This is clearly a huge area, and the best one can say for the moment is that *if* SEBI is convinced by the insider trading argument as applied to institutions and their nominees, it should seriously consider establishing minimum requirements for Chinese Wall procedures.[50] The advantage of this would be that it would weaken the case for using the insider trading argument to press for removal of institutional directors from boards. The second argument (b) is exemplified in the written responses submitted by the chairman of one of the country's most successful NBFCs. He stated,

> *Investment institutions may see board representation as a a result of their debt exposure to the company. However, this representation should be triggered off by the happening of an event detrimental to the working of the company rather than as a matter of right.*

The same position was taken by the senior manager of a large business house:

> *We believe that institutions, merely because they have the financial exposure, they should not have a place on the board. (By financial exposure you mean equity?) Equity as well as debt (As well as debt?) Yes. Let's tackle the two things separately. As far as debt is concerned, we believe that until and unless there is a potential default or an event of default, not necessarily actual default of payments but let's say slippage on project milestones, etc., until and unless there is a significant event that affects the ability of the company to service its loan, the institutional lenders should not have a place on the board. And financial institutions which are equity holders, merely because they are equity holders they should not have a place. (What's the logic behind this?) The logic is that in front of other stakeholders, these institutional nominees actually become institutional nominees, while the role of the board is actually a combined role.*

Of course, the institutional response to the first part of this statement might be that their directors are frequently criticised for not being sufficiently 'proactive', whereas keeping representatives on hold, so to speak, until a default is *likely* to occur will only constrain their ability to act proactively even more. The second part of the statement, with its reference to the 'combined role' of the board, takes us to the final argument (c), which is the most complex of the three. Thus one respondent argued:

> *As soon as the financial institution in its capacity as a shareholder wants a seat on the board, then it becomes answerable to the other shareholders. It cannot then say, I'm a shareholder, the board must be answerable to me. Because he's himself a part of that board. And, therefore, I would say that this is a tradition which is followed in the Anglo-American countries also: none of the big institutional investors in the U.S., for example, are represented on the boards of companies, because it affects their independence.*

Here the argument seemed to be not that *lenders* did not have a right to appoint their nominees to the board, but that shareholders who did so or sought board representation would lose their independence and not be able to hold the board accountable. One can respond to this by saying that to be consistent it presumes boards which are totally independent of *all* shareholder representatives, which seems unrealistic, given that most boards in India do have a significant presence of promoter nominees (see Table 1).

However, the issue is really whether accountability can work without making directors dependent on specific shareholders.[51]

The contrary position, defending the institutions' presence on the board, was largely made to hinge on an assertion of shareholder rights:

> *If the board is taken as the representative body of the shareholders, then every class of shareholder is entitled to have a representative on the board, who gets duly elected by the shareholders* (institutional head);
>
> *How can you tell a shareholder 'you cannot be represented on a company'?* (institutional executive);
>
> *I think the financial institutions and banks which have a very large stake in these companies are bound to have a say in these matters, and I would not deny them that right, they must have that* (former head of institution).

Most forcefully, perhaps, in the following statement:

> *(About this more specific recommendation that the investment institutions should withdraw their nominees?) It's a completely absurd provision! It's a completely self-serving provision, and it speaks volumes for the mind-set of this Committee that they don't recognise the rights of the shareholders - when it's the whole purpose of corporate governance, one of the purposes, is that they recognise all shareholders as equal* (private equity fund).

It was also claimed that insider trading was more rampant among promoters. The same respondent went on to say:

> *The insiders, the management is the principal culprit in insider trading, in India today! And here the onus is being put on investment institutions. I think it's absurd. The investment institutions must safeguard their responsibility. Often we've found it's the investment institutions that have safeguarded the rights of all small shareholders, not the managements.*

One fund manager thought it was wrong to link the argument about insider trading with the issue of board representation:

> *Here I think the approach is wrong...that because there are no proper checks and balances on insider trading, you don't want institutions to be a part of the board. That, I think, is probably a wrong argument. You should actually have proper checks and balances for insider trading, there is no substitute for that in a capital market. If you're saying, that is not there, therefore you should not have them, we're tackling the wrong end of the problem.*

The argument that lenders should appoint nominees only if a default is likely was met with the reply:

> *This is funny - our nominee directors are there exactly to avoid default. After it becomes default and becomes an NPA, what is the use of that? That is something we don't agree to. Moreover, I have a responsibility to the public shareholder. Otherwise they have no forum. See, the whole institution of nominee director came that way* (institutional manager).

And finally, there were professional non-executives who said they disagreed with the suggestion:

> *I have a bit of a dilemma that if I'm either a significant shareholder or a lender to you, I think I should be on your board, and the way to protect you and the company from price-sensitive information being issued is, I think the company should enter into a covenant with such board members specifically…That is one point that I disagree with SEBI* (MNC non-executive chairman);
>
> *(Q. on SEBI recommendation to remove nominees from boards) I would certainly oppose that.. I don't know about the small companies, fortunately I'm on quite a few good companies, where high-level executives are representatives of financial institutions. And they are quite vigilant…(Do you find it surprising that SEBI might actually come out with a recommendation of this sort? Does it surprise you?) It did...when I read it in the papers, it surprised me. I don't know what motivated them to do that* (lawyer).

The counter-response to SEBI's draft recommendation could then be summed up as follows. The issue of insider trading is logically independent of the question of board representation for institutional investors (or any other class of shareholders), in the sense that the latter is a question of principle and cannot be settled by looking at the effectiveness of the Chinese Wall in institutions that trade in equity. In fact, the efficacy of Chinese Walls is notoriously problematic, and full disclosure may well be the best antidote to the problem of insider trading.[52]

The other group of institutional investors who have had a significant impact on the Indian market are the so-called foreign institutional investors or FIIs. There was a widespread perception among respondents that much of the change in the market has in fact been driven by the FIIs through their pressure for a central depository, better standards of disclosure, regular interaction with managements, and the brute exercise of market force. FIIs look for companies which they feel are going to be internationally competitive and exert a diffuse pressure on Indian managements to build professionally run, transparent, competitive businesses, similar in many ways to the 'functional convergence' effect described by Coffee with respect to securities market integration and the influence of overseas listings.[53] One of the most fascinating discoveries in the course of this study was the sheer extent of interaction between research analysts or fund managers and top management. Interviews with senior executives established that huge amounts of time are spent meeting with analysts and fund managers on a collective or individual basis. Even foreign subsidiaries with a low FII stake described themselves as devoting significant amounts of time to such meetings. *A nuisance, but there it is, you can't turn them down and you can't tell them lies,* was how one managing director of an Indian company described his feelings about meeting fund managers the next day. Asked if integration into global financial markets had affected the climate of corporate governance in India, another CEO replied, *I'm not very sure if it has affected corporate governance in India, but what it has affected is definitely the anxiety level of the CEOs…Earlier I had to satisfy Mr ** and **, once a year, in the AGM. Today you have to satisfy every investor every day*. In the light of all this evidence, it would seem crass to imagine that the Indian market has not seen a dramatic transformation in the course of the nineties which is closely bound up with the entry of international investors.

Having said that, it is much less easy to be certain about how far the FIIs will seek actively to shape the culture of accountability in the corporate sector. Fund managers see themselves as 'passive investors' who have the potential to influence corporate behaviour by dumping stock and affecting companies' ability to raise money in the market. (There are numerous instances of companies responding to institutional pressure in this form.) None of the fund managers we interviewed saw themselves taking board positions:

> *We are not interested in a position on the board, we are just passive investors as far as the company is concerned* (fund manager);
>
> *We are not long-term strategic investors...By and large you vote with your feet, you exit, dump the stock if you're unhappy with the management...By and large we vote with our feet* (fund manager);
>
> *Foreign institutions don't want to sit on boards. They have the right in many cases and don't* (consultant).

Nor is it clear that the mutual fund industry will make regular use of its voting rights to seek more forthright ways of influencing management. In a discussion with a group of fund managers at one of the Indian mutual funds it was said:

> *We haven't got used to the idea of voting in a meeting yet. All these years we've never had a vote. Therefore, there have been many meetings which we've not attended, having nothing better to do. Now that we have the vote and we can exercise it, and our opinions will be heard, we are also looking at this much more seriously.*

Of course, the trend internationally is for investor networks such as the ICGN to propagate the active use of voting rights by institutional investors and the lowering of barriers to cross-border share voting.[54] 'It is now widely accepted that the right to vote a share has an economic value.'[55] But with investment time frames of 12 to 24 months, it is unlikely that there is a strong incentive in the Indian market to translate that kind of prescription into reality.[56] As one fund manager stated, *We'll have to wait for long-term players with reasonably large exposures to India.*

Perspectives

Where, then, does the cutting edge lie? There is no doubt that company initiatives have played an important role in India and that a handful of corporates have gone out of their way to replicate best practice ideas in corporate governance.[57] This is obviously particularly true of the disclosure and reporting standards pioneered by Infosys and, to a lesser extent perhaps, the growing willingness among Indian companies to 'try out' US GAAP. On the other hand, it still remains true that there are very few very good companies in the country, unlikely that their governance initiatives can be seen in isolation from their strong performance as businesses, and doubtful whether corporate governance élitism will make much difference to the mainstream of Indian businesses, large and small. There is also the wider (or deeper) problem of whether constructing a formal architecture of corporate governance does address the underlying issue of corporate accountability, in other words, the problem of the limitations of the Cadbury model.

There was a widespread view among our respondents that corporate governance should be left 'to the market'. However, most of our interviews were conducted in 1998 and 1999, during a downward phase of the business cycle, and one of the most perceptive points made in the discussions, especially by some fund managers, was doubting the efficiency of a such a market as a measure of rewards to governance. *I don't know whether the market would have done the same thing when things were looking up. We saw preferential allotments by promoters at ridiculous prices, and at that time, when the market was moving up, most of the investing community took it, they didn't create much of a furore over that.* The general implication here is that the market is a rather blunt instrument of governance, conditioned as much or more by the state of the business cycle as by fund managers' perceptions of management quality and governance. Thus there is a need, and scope, for at least two other kinds of governance agendas, namely, regulatory intervention and institutional monitoring.

To take these points in reverse order, it was really quite striking how many respondents reposed faith in the possibilities of institutional activism, *despite* the severe criticisms meted out to the nominee director system. This was a genuine surprise, given the climate in which it was expressed, namely, the need to free business from controls, reduce government intervention, etc. It became apparent, however, that a rise in institutional activism was seen as premised on the growing autonomy of the institutions from government control and interference, their increasing professionalisation, and their responsiveness to their own shareholders and the public at large. What was also striking was the considerable diversity of backgrounds from which the support for a more aggressive institutional role was expressed and articulated. It may be helpful to separate the two propositions before illustrating them, firstly, that institutional activism is inevitable in the long term, it is bound to come; and secondly, that the domestic financial institutions need to be more aggressive. Here are some responses:

> *(Are you even slightly optimistic about change in the level of activism or quality of activism from the FIs, that they will…) I think it will come about, yes. I don't think this apathy can last forever. It should come, but I just hope it comes in the right manner. Until now, the biggest protest that an FI has done is probably abstain from voting - which is not really helpful, in the sense that if a motion is to be blocked, abstention from voting is not the answer. You should vote against the motion, so you have that solid 20% or 30% or 40% going against that motion* (fund manager in group discussion at an Indian mutual fund);
>
> *Shareholders like institutions will start asserting their rights...Litigation, active involvement from institutions to protect their rights - these will be the driving forces today* (private equity fund);
>
> *If, for example, in India you had the equivalent of CalPERS of the United States, and some of those pension funds, those pension funds are employing very capable accountants, lawyers, and business drivers on to the boards of companies, and I think that will come here, it's bound to come…it has to come…(Are you suggesting that the size of the institutions' stake in most private sector firms will make it difficult for them to actually just exit now, and they have to become more actively involved?) They can't just exit, they'll crash, and drag the market* (managing director of a large business group company with a 24% institutional stake).

The sheer size of domestic institutional stakes distinguishes the Indian corporate governance system in a remarkable way from most others in the world, and Coffee's assertion that 'As the scale of institutional holdings grows, the expected gains from activism should increasingly outweigh the losses' has an obvious relevance for India.[58] The general issue here is how the institutions can best exercise their governance responsibilities, and the most interesting responses were that they should use their voting power, not hesitate to bring about a change in promoters, and auction their holdings in the emerging market for corporate control. One's impression from these responses was that this would be the single most powerful means of reshaping the governance culture of family-owned businesses - more powerful than regulatory pressures, which can always be accommodated, and certainly more persuasive than a mere reliance on codes of best practice. It is worth re-emphasising, however, that a perspective of this kind presupposes that the institutions are no longer government directed entities, have the autonomy to make the best decisions in terms of their own interests as institutional shareholders and their responsibilities as trustees of public wealth, and have the professionalism and flexibility to combine a core portfolio with a trading component, concentrating professional monitoring skills on the former. Seen in this perspective, there is no need for institutional shareholders to overstretch their own resources in monitoring managements. Several respondents suggested that they should rely primarily on a panel of non-official nominees, independent outside directors appointed at the behest of the institutions, who would act as representatives of the general shareholder interest. Such directors would be genuinely independent of management, both in the sense of having no affiliation with the company or group, and in the sense of being responsible to their appointors. They would function primarily in the huge grey area of Indian business which lies sprawling between the handful of genuinely professionally managed companies and the mass of family concerns where there is no significant public stake.

Here, then, are some of these responses:

> *Vote out the promoter directors! Put your own people in…Where there's a will, there's a way.. I think they are moving in that direction, I have to say to their credit, that they're moving in that direction, if for no other reason than the fact that they have to survive, and they have so much bad debt on their books…(With institutions becoming more aggressive, how do you see them actually dislodging bad managements?) To vote against the resolutions for their re-appointment. (In other words, the AGM is the essential forum?) Absolutely! And if you've got 30%, the other shareholders that come will muster 2 or 3%, the promoter may have 10 or 15 or 20%, you'll be able to knock them out. (Do you see them doing this in the next few years?) That's for you to ask them, I can't comment* (MNC chief executive);

> *If the institutions were to assert themselves a little more, and start selling companies, start changing managements, when they find under-performing or non-performing managements, I think we will see a sea-change. Even today the perception is that the institutions dance to the tune of North Block. That has to change* (MNC director);

> *I think the public financial institutions hold a sizeable lot of shares in a large number of companies, and, irrespective of performance, they have continued to hold them, in the process destroying value for themselves. I would really say that bringing about a change in promoters and inducting a new set of promoters if the company is not performing is something which would really, to my mind, bring about far better results than any other form of corporate governance you may talk about.) (But that presumes a takeover market which doesn't exist at the moment?) Oh, there's plenty of it! Who says it doesn't exist?(You think there is a market?) There is a market in India and I think it's a question of freeing the institutions from a certain degree of political interference* (same director, separate interview);

> *Financial institutions today have a large enough block where they can create serious damage to...serious nuisance value they can create, by auctioning off their block to the highest bidder* (former head of equity research).

Finally, and most revealingly,

> *(I suppose the standard argument there is that the takeover market acts as a sort of discipline on the under-performing companies…) [Chairman] It will largely happen that way, but right now, of course, to put it politely or impolitely, you use your contacts, political and otherwise, etc., to see that takeover bids…hostile takeover bids don't succeed, so you go along to the financial institutions, etc., whatnot, put pressure on government, it's happened in the past, it's likely to happen...this takes its*

> *place.. [Jt managing director] the day the government lets loose these institutions, in terms of their control over them, you will certainly see a lot more aggressive activism from them* (heads of a large business house).

The key issues here, of course, are the government's likely response to the prospect of Indian promoters losing control to more successful rivals, foreign and domestic, as well as the problem of the liquidity of large holdings in the Indian market. Institutional respondents were more sceptical about the chances of finding buyers in a corporate control market. What is clear, however, is that as a market for acquisitions develops in India, aggressive institutional players will have greater leeway in deciding what to do with sub-standard managements, if they have the freedom to make those decisions. Mergers & Acquisitions will also speed up consolidation in fragmented industries and add scale to individual businesses.

The SEBI Code is clearly an attempt to replicate the form of the Cadbury Code in a context where the institutional presuppositions for 'self-regulation' are considerably weaker. The most damning criticism of the code in the course of our interviews came from two senior executives of one of the bigger multinationals. One of them argued:

> *Before having a Nominations Committee and an Audit Committee, you need integrity of business, because otherwise I fear an even greater danger, that the people that want to be dishonest will do so despite having all the committees, and will in fact find the committees as an excellent subterfuge to get about what they want to do.*

The argument here is one of form versus substance. Of course, whether the formal architecture of corporate governance will work towards fulfilling its stated aims (creating a more transparent and accountable business system) will have to depend largely on the role of the independent directors. But the Code abstains from prescribing nomination committees, espouses a narrow definition of independence, and fails to address the practical issues confronting most non-executives who wish to play a more active role, above all, lack of time. These are serious lacunas and reinforce the critique of a formalist subversion of the whole exercise:

> *Actually, my great worry is that as soon as this SEBI Code comes on, there will be wholesale skulduggery with a great degree of aura of the Committee…(In other words, formalism?) yes, and everything will carry on and they will feel even more confident – because you will have an "independent" director, in quotes, who will aid and abet you in all your ventures or adventures. (So, substantially, the degree of accountability won't necessarily be any greater?) It'll be far worse for independent third parties, and far better for promoter-shareholders. (Second director: …Our system has been built around the accountability and responsibility of promoters. On that system if you impose today the Audit Committees, the Nominations Committees, and the Complaints Committees or Grievance Committees, the net result would be that promoters' accountability would get substantially diluted.) They'll be delighted!... All the Indian promoters will be absolutely delighted! (Could you very*

> *briefly explain why exactly this would be the case?) I've already explained it to you, Mr. Banaji. The fact is that you will continue to do what you do but you will have the complete shelter and umbrella of protection [from] these Committees, and the committees will be staffed by a whole series of people who are, in quotes, as I said, "independent". (It boils down to not having genuinely independent directors, is that what you're saying?) Well, at the end of the day who will appoint them? Is the Central Government going to sit and appoint the independent directors?…And what can an independent director do? He would comment on what is brought to him, and that is where, at the heart of the issue, is the ethics and integrity inherent within a corporation – because otherwise you can comment on what is there for you to see. If you just…I personally believe that in India we are totally hung up with form rather than substance.*

The essence of this critique, then, is that the Code may lead to a dilution of the promoter's accountability through a process of window-dressing. Of course, there is no doubt that many of the better, more professionally run companies will use the opportunity to upgrade their systems of governance in the ways 'mandatorily recommended', and this will be a step forward. The issue raised by the mainstream of the business system is how the SEBI Code is going to impact the real integrity and culture of business in this country. Prima facie, the response is that the mandatory recommendations encourage corporates to adopt best practices. In reality the various committees may constitute an elaborate façade behind which many promoters continue to govern their businesses without any significant addition to integrity.

In short, a code of best practices will work best when reinforced by a new level of institutional monitoring and certainly should not be seen as a substitute for the role and responsibilities of the institutional shareholders, even if the occasion of a regulatory intervention was seen by many as being used to circumscribe rather than promote their rights. The two governance agendas have to work together in a kind of symbiosis, with much greater input from institutional investors into the drafting of regulations and self-regulatory exercises and a publicly transparent articulation of institutional policy.

5. Summary, recommendations, and final issues

Some of the main findings can be restated as follows:

(1) There is now a clear consensus that a substantial reform of governance is necessary in the Indian corporate sector, but much less clarity about the paths along which this should be pursued. Certainly, the most interesting development during this period has been the publication of SEBI's Code of Corporate Governance. A major criticism levelled at the Code is that it is 'more about methods and procedures than about substance'. The fact that the Committee which drafted the code was headed by Kumar Mangalam Birla was surely intended as a signal to the leading family businesses that it was not the regulator's intention to question the legitimacy of promoter control of businesses, but rather to lay down a framework of rules and principles to encourage

such businesses to operate in more ‘accountable’ and ‘transparent’ ways. The code reflects the global pressures on Indian business to revamp the system of governance around stronger, more professional boards, and to upgrade and internationalise its standards of disclosure and financial reporting. But it can also be read as an attempt to allow Indian businesses some measure of control over the sort of adjustments they will sooner or later have to make at *all* these levels.

(2) There was a widespread recognition among our respondents that non-executive directors have been ineffective and do not contribute sufficiently to the exercise of independent supervision. Professionals, the category which in theory best approximates the ideal of the independent director, complain of lack of time, lack of training, ‘subconscious’ loyalty to management, poor structuring of agendas, and the fear of full liability under the law. The SEBI Code says nothing about any of these issues, apart from its general exhortation that independent directors should ‘devote adequate time for meeting, preparation and attendance’. A crucial omission relates to the lack of any sort of recommendation for the introduction of nomination committees.

(3) The current globalisation of business includes mounting pressure for the introduction of international accounting standards, whether in the form of further, incremental adoption of provisions from US GAAP or the more sweeping move to a single set of International Accounting Standards which would be mandatory for all countries. In the Indian case, a crucial provision relates to consolidation of accounts. Investment bankers and fund managers are of course strongly in favour of consolidation, but the Indian accountancy profession could also take a much stronger stand on the issue. It has been suggested that if they demanded consolidation as a standard, even if it was not required by law, then the change would begin. Consolidation would strengthen transparency by helping to disclose the true extent of liabilities within business groups, unearthing the complex maze of cross-holdings through which promoter families have traditionally secured and funded control over corporate empires, and revealing the true economic strength of individual groups through the ‘netting out’ of transactions. An important related provision, clear in the auditor interviews, is disclosure of related party transactions, involving transactions with affiliated companies. One respondent noted humorously, ‘I am told that a couple of companies who wanted to go and get their shares listed in the US had to withdraw their application because the disclosure requirement on related parties was so stringent that they thought they would not be well received if they were to disclose all their related party transactions’.

(4) Institutional investors have a major role to play. The single most divisive issue we encountered in the course of this study was the whole question of the nominee director system and whether the public financial institutions should continue to retain a significant presence on boards. We have propounded the arguments for and against, suggesting that the promoter lobby has made a bogey out of a real problem (namely, the rampant nature of insider trading in the Indian market), seeking to use this to immobilise the institutions, but also that the nominee system needs a complete overhaul, with the institutions relying largely on outside independent directors insofar as they choose to be on the boards of companies. It is also suggested that government control of the financial institutions has been a constraint on their monitoring capacity, in the sense that the *political* influence wielded by promoters has shielded them from

accountability, despite the brazen plundering of many companies listed on the stock market. As the institutions evolve a more professional approach to issues of corporate governance, this should mean both less government interference (in the bad sense) and a stronger regulatory push in the direction of a more transparent articulation of institutional policy as well as better corporate governance in the banking institutions themselves.

The regulators of company governance would do well to consider the following suggestions:

- Broadening the selection of boards through nomination committees consisting chiefly of independent directors;
- Adopting a stronger definition of independence in keeping with international best practice;
- Requiring boards to be more demanding, e.g. through a legislative restatement of directors' duties;
- Making compliance with international accounting standards mandatory;
- Proposing the setting up of a panel of independent outside directors who would be willing to act as nominees of the financial institutions;
- Creating an obligation on institutional investors to make regular use of their voting rights and to state their voting policies.

A final set of issues: Mody's paper takes up the whole issue of regulatory fragmentation in India. As a conclusion to this part of our report, three other sets of issues are also worth reflecting on:

1. The Cadbury-style corporate governance initiatives of the 1990s set out to revitalise the board, encourage greater activism by institutional shareholders, and improve disclosure standards. The cornerstone of the Cadbury model is the board, and the first of the various issues we should note in concluding this report is Cadbury's belief in the efficacy of the board as a potentially powerful tool of supervision over management. Yet the evidence seems to point overwhelmingly to the 'limited desire of boards to monitor management'.[59] This may be because non-executive directors share management's culture of limited monitoring.[60] In any case, it is clear from our own study that, even in the best of companies, boards are strongly driven by management. As one director of a Tata company put it, 'I'm not very sure if you can really uncouple the board and the management'. Thus the first issue here is: *how effective can independent directors be?* And certainly, how effective can they be without a 'power base from which to insist on explanations or to impose appropriate remedies', e.g. a mandate from institutional shareholders who treat them as representatives of the general shareholder interest?[61]
2. The nominee director system is surrounded by considerable confusion at the moment. On the one hand, among the Indian financial institutions, it is the investment institutions not the term-lending banks that own the largest quantity of shares in private sector companies. On the other hand, the nominee director system evolved as

an offshoot of the loan agreements of both term-lending and investment institutions, and the constitution of the panel of nominee directors was hemmed in by restrictions due to reservations from the private sector: for example, companies objected to the appointment of CAs as institutional nominees.[62] It is surely time these confusions were cleared away by a clear statement of the rights of institutional investors as well as a clear definition of institutional shareholder policy and strategy. There are several issues here:

2.1 *How do we make the nominee director system more effective?* Should the institutions continue to appoint their own employees and retired officials as nominees? There is an attractive view that in future they would do best to rely primarily on a panel of independent outside directors who seek appointment at the behest of the institutions and see themselves as representing the general shareholder interest. Such directors could be drawn from a very wide range of backgrounds and may need to be equipped in governance by the requisite level of training.

2.2 *Should the institutions be prevented from trading in the shares of a company where they have such directors?* The head of one of the more reputable exchanges in the country raised this issue at a workshop in Bombay, stating that the institutions were being immobilised in their governance role by the fear of handling 'inside' information. He argued: *If we really, all of us, believe that the institutions have a role to play, then we have to resolve this basic issue. If institutions really take interest in the company, then can they be totally prevented from market operations in that company because of the insider trading problem? In the literature on corporate governance about the role of institutions etc., this point comes up frequently. If institutions cannot operate freely in the market, then they will not take interest in corporate governance. They will have a purely free ride. And if a free ride situation develops, I think we as a democratic society will have a serious problem. Are we going to run corporate governance purely through the executives who run the company and shareholders have no say?*

2.3 'Institutional investors have the potential to exert significant influence on companies via their voting rights, and this has clear implications for corporate governance'.[63] Moreover, in the US, 'There is a fairly widespread feeling that to vote blindly for management is essentially a violation of ERISA's requirements and may have a detrimental effect'.[64] So the final issue here is *how can institutional investors (of whatever type) be encouraged to exercise their voting rights and disclose their voting policies?* The SEBI Code is not sufficiently clear on this question.

3. *Finally, is there sufficient legal protection for minority investors?* Lack of liquidity in the Indian market is chiefly a function of the absence of a strong domestic investment management industry based on pension funds and life insurance money, but also, to a considerable degree, linked to the lack of strong legal protections for minority shareholders. Several respondents in this study took the stand that there was nothing wrong with preferential allotments as long as they occurred within the SEBI guidelines. By contrast, responding to an earlier draft of this report, one interviewee stated, *The whole 'principle' of preferential issues is anathema to a well-run stock*

market. It should never happen at all under any circumstances. The idea that there are different rules for the manner in which the proprietors can trade in their shares from anybody else has no place in a modern stock market. The regulatory authorities will have to decide which view they support.

References

1A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (New York, 1932)
2Julian Franks and Colin Mayer, ‘Corporate ownership and control in the U.K., Germany and France’, in D. H. Chew, ed., *Studies in International Corporate Finance and Governance Systems* (New York and Oxford, 1997) 281-96, e.g. ‘large-block family ownership is a highly representative feature of the largest enterprises in Germany’ (286).
3E.g., Stijn Claessens *et al., Who Controls East Asian Corporations?* (The World Bank, Policy Research Working Paper 2054).
4 David Blake, *Pension Schemes and Pension Funds in the UK* (Oxford, 1995), OECD, *Institutional Investors in the New Financial Landscape* (1998).
55 J. E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford, 1993) 192, calls this ‘market-induced, evolutionary governance reform’, which seems an apposite description.
6The meeting received considerable publicity: see ‘Corporate governance code proposed’, *BS* 10.9.96, ‘Adrian Cadbury to help CII draft corporate governance’, *BS* 30.10.96, ‘Corporate codes can’t be imported, but evolved: Cadbury’, *ET* 27.11.96, ‘Khan wants FIs’ role in company boards redefined’, *BS* 29.11.96.
7This contribution to our final report is based on a total of 158 interviews conducted mainly in Bombay between April 1998 and January 2000.
8B. R. Cheffins, ‘Corporate governance in the UK: lessons for Canada’, *Canadian Business Law Journal* 28 (1997) 69 ff., at 82.
9Securities and Exchange Board of India, letter to the stock exchanges dated 21 February, 2000.
10London Stock Exchange, *A Practical Guide to Listing on the London Stock Exchange* (2000), 21.
11For these criticisms, see Vanessa Finch, ‘Corporate governance and Cadbury: self-regulation and alternatives’, (1994) *Journal of Business Law*, 51-62.
12Gerald S. Backman, ‘The new audit committee rules’, *Securities Regulation Law Journal* 28 (2000) 3-14.
13Ada Demb and F. Friedrich Neubauer, *The Corporate Board* (New York/Oxford, 1992) at 113.
14As ‘rubber stamps’, ‘dummy boards’, ‘showpieces’, ‘cronies’, ‘buddies of the chairman’, ‘closed clubs’, ‘notoriously weak’, and, most vividly, as ‘the emperor and his dogs’. ‘Dummy boards’ was how a leading industrialist described the boards in his own group of companies!
15Peter Clifford and Robert Evans, ‘Non-executive directors: a question of independence’, *Corporate Governance* 5 (1997) 224-31, at 230.
16R. H. Patil, ‘Corporate governance in India: some ground realities’, *Management Review* 9 (1997) 37-42, at 39.
17For example, *yes, you need outside directors, need them in specific contributions, and compensate them much more than is being done right now, etc., but having said that, are there enough of them? Are there any of them around?* (industrialist).
18Mahmoud Ezzamel and Robert Watson, ‘Wearing two hats: the conflicting control and management roles of non-executive directors’, in K. Keasey, S. Thompson, and M. Wright, eds., *Corporate Governance: Economic and Financial Issues* (Oxford, 1997) 54-79, at 69.
19Vanessa Finch, ‘Board performance and Cadbury on Corporate Governance’, (1992) *Journal of Business Law,* 581, at 592f.
20See Department of Trade and Industry, *Modern Company Law 5: Developing the Framework* (March 2000) at 67ff.
21On NYSE and NASD definitions of ‘independence’, crucial to the proper constitution of audit committees, see G. S. Backman, ‘The new audit committee rules’, 8ff.
22Christopher Stanley, ‘An approach to the internal regulation of the corporation: a critical analysis of the recommendations of the Cadbury Committee’, *J. of Financial Regulation and Compliance* 2 (1993)
23‘FIs to put corporates who do not behave on notice’, *ET* 9.9.96.

[24] This was stated in so many words by the Chairman of one of the largest institutions: *whereas it is one thing to enjoy the right to appoint a person as a director, it's another to exercise that right*.

[25] See John C. Coffee, Jr., 'Liquidity versus control: the institutional investor as monitor', (1991) 91 *Columbia Law Review*, 1277, contrasting institutions with long-term trading strategies (esp. pension funds) and active traders (notably, mutual funds).

[26] Not a taped interview; transcribed from notes.

[27] 'Montek wants FIs to take active role in company boards', *ET* 29.11.96, reporting the views of S. H. Khan. Cf. similar observations in P. S. Subramanyam's speech to the CII workshop on corporate governance held in Bombay on 4 August 1999, arguing strongly that 'boards should be privy to information': author's notes at the workshop and 'UTI chief urges higher quality of disclosures', *BS* 5.8.99.

[28] Pricewaterhouse Coopers, *Audit Committees: Good Practices for Meeting Market Expectations* (May 1999) 7.

[29] Pricewaterhouse Coopers, *Audit Committees*, 8.

[30] See Laura F. Spira, 'Ceremonies of governance: perspectives on the role of the audit committee', *Journal of Management and Governance* 3 (1999) 231-260, at 255.

[31] See Backman, 'Audit committee rules', (n. 12).

[32] Cited Backman, 'Audit committee rules', 9.

[33] Lubna Kably, 'A re-look at independence', *ET* 14.12.99.

[34] Parkinson, *Corporate Power*, 194.

[35] S. D. Israni, 'A toothless tiger', *ET* 5.9.97.

[36] See Franks and Mayer, 'Corporate ownership and control' (n. 2 above) 293ff. for the idea.

[37] See R. K. Hazari, *The Structure of the Corporate Private Sector: A Study of Concentration, Ownership and Control* (London, 1964). The regulation of investment companies was a major recommendation of Hazari's report, but soon forgotten, unsurprisingly.

[30] Doreen McBarnet and Christopher Whelan, 'The elusive spirit of the law: formalism and the struggle for legal control', *The Modern Law Review* 54 (1991) 848-73, at 850, citing Ernst & Young, *UK GAAP*, 647.

[39] Amal Ganguli, interviewed in 'Independent audit crucial to markets', *BS* 8.11.96.

[40] Mike Davies, Ron Paterson, Allister Wilson, *UK GAAP* (Macmillan and Ernst & Young, 1997) 1063.

[41] Davies *et al.*, *UK GAAP*, 1079.

[42] IAS 24 on related parties proposes the following definition:
Related parties are those able to control or exercise significant influence. Such relationships include:

1. Parent-subsidiary relationships (see IAS 27).
2. Entities under common control.
3. Associates (see IAS 28).
4. Individuals who, through ownership, have significant influence over the enterprise and close members of their families.
5. Key management personnel.

[43] For the UK, see G. P. Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford, 1996).

[44] Stapledon, *Institutional Shareholders*, 128, argues that in the UK 'most institutions consider it preferable to sell their shareholding where possible rather than undertake an intervention'. He states that 'The possibility of an alternative course of action to intervention is the greatest disincentive to an institution intervening' (129). Counteracting this is the fact that 'greater concentration of shareholding makes monitoring more rational for large shareholders', partly because it 'decreases the benefits from alternative courses of action' (256). In spite of this, however, in the UK at any rate, 'most large fund managers [are] still more likely to sell than intervene when serious managerial problems arise' (257). Stapledon then explains this in terms of what he calls a 'formidable set of obstacles to serious intervention by managers of external funds' (266), which include (a) collective-action and free-rider problems, (b) the way in which the performance of external fund managers is measured, (c) financial constraints, (d) the growing popularity of index funds (on which see Booth and Wrighton, 'Down, but not out', *Institutional Investor*, July 1999, 45-50), and the resulting absence of any significantly overweight holdings, and (e) 'structural conflicts of interest', namely, the fact that fund-management firms may be subsidiaries of merchant-banking companies or 'financial conglomerates' (see 255-66). This discussion is helpful

because it shows how much stronger the potential for increased monitoring is in the Indian corporate governance system, insofar as none of the disincentives just listed apply, with the modified exception of a financial constraint, namely, a lack of high-quality or sufficiently qualified personnel to act as non-executive directors, either independently or as nominees. Disqualifying (a) is the historical fact that the FIs have always worked through a coalition of institutional interests, sharing nominees, for example. The second factor, (b), has no bearing because it applies to the external management of funds, which is not the pattern in India. The fourth obstacle is likewise irrelevant since index funds have barely taken off, though the picture could change substantially in the future. Finally, domestic fund-management groups do not operate as part of larger financial conglomerates, so (e) fails to apply. On the other hand, it is probable that most of the disincentives described by Stapledon, and his general argument, *do* apply to the so-called FIIs.

45Paul L. Davies and G. P. Stapledon, ‘Corporate governance in the United Kingdom’, in M. Isaksson and R. Skog, eds., *Aspects of Corporate Governance* (Stockholm, 1994) 55-81, esp. 72; also Stapledon, *Institutional Shareholders*, 67, where he states, ‘compliance by companies with the Cadbury Code is..a measure - albeit an indirect one - of institutional influence in UK corporate governance’.

46What cannot be said, of course, is that the comparative failure of the CII Code was due to an excess of rigour. Contrary to best practice, even in India, the code rules out the need for nomination committees, disingenuously suggesting that ‘securing the services of professionally competent directors’ does not necessitate having such committees. It recommends that 30-50% of the board should consist of ‘independent, non-executive directors’, without advancing any definition of ‘independent’. (In our study we found that most managements automatically regard their non-executives as ‘independent’, so adding this epithet to ‘non-executive’ does not make a substantial difference unless one has something more in mind.) The code also rules out remuneration committees, although these had been part of the recommendations of the draft report (see ‘Companies under fire over selection policy for non-exec directors’, *ET* 3.2.97 where the draft is said to recommend that ‘Listed companies should also have remuneration committees consisting of the CEO and three to four non-executive directors’). Most significant, perhaps, is its conception of the role of the ‘independent’ director as consisting, in part, of ‘appreciating the issues put forward by management’. It was left to a company secretary to point out, ‘The committee’s assessment of the role of such professionally independent directors does not seem to be correctly expressed. The role of the independent directors is to act as a foil to the management…The use of the words ‘appreciating the issues put forth by the management’ is therefore misplaced and should be read as ‘independently assessing’. ’ (B. J. Shah, ‘The cover and the pages within’, *ET* 16.5.97) If, in spite of these obvious concessions, the code failed to inspire the mass of the Indian business community, the experience should prompt us to ask whether it makes sense to conceive of self-regulation purely and simply as an *alternative* to stronger regulatory intervention.

47See ‘Unfair demand’, edit., *ET* 31.5.99, where the argument runs, ‘There seems no reason why institutional shareholders should be treated differently from any other class of shareholders. It is doubtful whether the CII would demand that other shareholders with, say, 15 per cent of the equity of a company should not seek a place on its board. Why then should such a demand be made from the institutions, especially when all of them put together often hold as much as 40 per cent..? *One reason could be that by virtue of their presence on the board, they would be privy to information that they could use to their advantage as players on the stock market. But this would be just as true for all members of the board’.*

48‘Chinese Walls’ are a self-regulatory device to stop the flow of price sensitive information within a corporate entity through compartmentalisation. The most extreme form of such segregation is the creation of separate subsidiaries within the group. See Harry McVea, *Financial Conglomerates and the Chinese Wall: Regulating Conflicts of Interest* (Oxford, 1993).

49McVea, *Financial Conglomerates*, 133. The local head of a British banking group who argued that ‘Chinese Walls are certainly not a myth in well run companies’ described the position in his bank as follows: *At the working level, our experience is that Chinese Walls work extremely well. At the very senior level - and this could only cover normally in a company not more than ten people - they are (the jargon is) ‘above the Wall’, because they have to take decisions about what the investment bank can do. And they are people that are aware of the damage that could come to an investment bank if the view in the market was that information which shouldn’t be was leaking and the company was taking advantage of it. And it would quickly become apparent because you couldn’t: in an institution like this, if you’re* *going to take a position, it's got to be a big position to make any difference, and you can't hide that from the market. So I think in the trading aspects Chinese Walls do work.*

[50]Again, cf. McVea, *Financial Conglomerates*, 125, stating, 'Recently in the USA there have been calls to outline criteria for minimum Wall procedures'.

[51]Cf. Paul L. Davies, 'Institutional investors in the United Kingdom', in D. D. Prentice and P. R. J. Holland, eds., *Contemporary Issues in Corporate Governance* (Oxford, 1993) 69-96, esp. 93, arguing that true independence of management 'can only be achieved in a reliable way by making the non-executives dependent on another powerful group within the company'; supported by Stapledon, *Institutional Shareholders*, 145-6, 293.

[52]See McVea, *Financial Conglomerates*, 214ff. and 227ff. for each of these assertions.

[53]John C. Coffee, Jr., 'The future as history: the prospects for global convergence in corporate governance and its implications', (1999) 93 *Northwestern University Law Review* 641.

[54]See T. Baums and E. Wymeersch, eds., *Shareholder Voting Rights and Practices in Europe and the United States* (Kluwer Law International, 1999).

[55]Department of Trade and Industry, *Modern Company Law 5* (n. 20 above), 86. The full statement reads, 'It is now widely accepted that the right to vote a share has an economic value and that those who hold voting rights on behalf of others have a fiduciary responsibility to consider whether (and if so how) to vote'.

[56]See the survey of institutional investors in Dewe Rogerson, *Findings of Perspective India III: General Section* (June, 1998). I am grateful to Rosie Catherwood for permission to cite the general section of this valuable survey.

[57]Note Cadbury's recently stated view, 'The drive to produce codes of good governance came from different groups in different countries. In the UK it was the financial sector, in France and India it was companies themselves, in Hong Kong the accountants took the lead, in Spain it was the government, (etc.) ', in Sir Adrian Cadbury, 'The corporate governance agenda', *Corporate Governance* 8 (2000) 7ff., at 9.

[58]Coffee, 'Liquidity versus control', 1322.

[59]Sigurt Vitols *et al.*, *Corporate Governance in Large British and German Companies* (London, 1997), who also note, 'In all companies in both countries..the initiative clearly lies with top management' (at 15).

[60]Davies, 'Institutional investors in the United Kingdom', 93f.

[61]Parkinson, *Corporate Power*, 194.

[62]These remarks are based on a presentation made by Dr R. H. Patil at a workshop organised in Bombay by Queen Elizabeth House, University of Oxford in September 2000.

[63]Chris A. Mallin, 'The voting framework: a comparative study of voting behaviour of institutional investors in the U.S. and the U.K.', *Corporate Governance* 4 (1996) 107ff.

[64]Mallin, 'Voting framework', 110, referring to The Employment Retirement Income Security Act which established fiduciary standards for private pension funds in the US.

Tables

Table 1: Board composition: sample companies

(Number of directors)

Company	**Size of board**	**Executive directors**	**Non-Executive directors**	**Promoter nominees**	**Institutional nominees**
P&G	8	2	6	4	
Colgate	8	3	5	2	
Hoechst 8	1	7	5 Hoechst + 3 UB		
Novartis	9	1	8	6	
Cadbury	12	6	6	2	
Hindustan Lever	12	10	2		
ICI	10	4	6	1	
Glaxo	11	4	7	3	
Castrol	8	4	4	2	
ABB	9	2	7	5	
Pfizer	11	1	10	8	
Philips	9	2	7	3+	1
Average for MNCs	9.58 (115)		65.2% (75)		
Asian Paints	9	4	5	6	
BSES	9	3	6	0	4
Hindalco	12	1	11	2	2
Tata Steel	13	1	12	4	2
Marico	5	1	4	3	
Rallis	9	1	8	3	1
Nicholas	15	7	8	3	1 p.e.f.
Mahindra & Mahindra	19	5	14		
Voltas	12	3	9	3	
Wockhardt	8	2	6		
ACC	16	4	12	4	2
Crompton Greaves	11	4	6		
Larsen & Toubro	17	6	11		4
HDFC	14	4	10		
Ceat	15	1	14		
Great Eastern	11	4	7	5	1
Gujarat Ambuja	12	4	8	5	1
Indo-Gulf	10	2	8	3	2
Nocil	9	3	6	2	2
S. Kumars	11	3	8	4	2
Infosys	10	6	4		
Titan	9	1	8	4 + 3 Tidco	
Herdillia	11	1	10		2
Reliance	12	6	6		2
Dabur	13	8	5	6	
Hero Honda	10	4	6		
Average for Indian cos 11.6 (302)		70.2% (212)			

Table 2: Sample Company Responses on Audit Committees, Segmental Reporting and Accounts Consolidation

Company	**Audit committee**	**Segment reporting**	**Consolidation of accounts**
P&G	0	No objection	Strong support
Colgate	0	Not unless statutorily required	Strong support
Hoechst	0	In favour	Strong support
Novartis	0	Only if required	Support
Cadbury	Set up *c.*1996	Only if required	'Haven't thought it through'
Hindustan Lever	0	Qualified support	Strong support
ICI	Set up bef.1990	Qualified support	Strong support; do consolidate
Glaxo	Set up 1998	Only sales & overall profitability	'It would be very welcome'
Castrol	For several years	Strong support	Strong support
ABB	For several years	No objection	Makes sense if it's tax driven
Pfizer	0	Prepared to do so if required	'Doesn't really affect us'
Philips	Set up in 1999	In favour	Strong support from one manager, CEO less enthusiastic
Asian Paints	5-6 years	Willing	'We can undertake to consolidate such changes come through'
BSES	8-10 years	Apparently in favour	'Will consolidate'
Hindalco	0	Not averse to it if required	Conflicts with segm. reporting
Tata Steel	Set up early 1980s	P&L disclosure, not costs	Where juggling goes on, yes
Marico	0	Not if it's quarterly	Qualified acceptance
Rallis	For many years	Not unless required	Support
Nicholas Piramal	Last 2 years	Willing	Support; 'want to consolidate'
M&M	Set up in 1987	Not willing	Not in support
Voltas	'Very powerful'	'To our board, yes'	'We have no problem'
Wockhardt	0	Strong support	Strong support
ACC	Set up *c.*1994	Qualified support	Support
Crompton	Set up *c.*1995	'first company to disclose'	Strong support
Larsen & Toubro	Set up early 1980s	Not willing	May reduce transparency
Ceat	0	??	Can't see how it will help
Great Eastern	Last 3 years	Support	Support
Gujarat Ambuja	Since 1986	Strong support	Support
Indo-Gulf	Set up recently?	Qualified acceptance	Qualified acceptance
Nocil	Poss. early 1980s	Willing	Support
S. Kumars	Set up *c.*1997	Willing	Support
Infosys	Set up in 1997	Strong support	Strong support
Titan	Set up in 1999	Willing	Strong support
Herdillia	0	Supports this for conglomerates	Support
Reliance	Recent?	Adopted from 1.4.00	Will consolidate from 1.4.00
Dabur	Set up in 1998	Yes, if future plans are not disclosed	'We have plans to consolidate'
Hero Honda	Last 4-5 years	Support	No clear views on the subject

Table 3: Key provisions of US GAAP which India should introduce (Auditor responses)[1]
(Cited in the order in which they were mentioned; 1 = most important)

Accountant	**Mentioned first**	**Mentioned second**	**Other provisions mentioned**
AA	Consolidation of accounts	Deferred tax accounting	
RA	Related party transactions	Accounting for leases	Depreciation
DC	Consolidation of accounts	Non-capitalisation of indirect expenses	Foreign currency transactions, segmental reporting, related party transactions
AD	Consolidation of accounts	Segmental reporting	Related party transactions
AG	Related party transactions	Consolidation of accounts	Segmental reporting, Accounting for intangibles
SH	Consolidation of accounts	Valuation of inventories	Disclosure of contingencies
UJ	Segmental reporting	Deferred tax accounting	Consolidation of accounts
YK	Consolidation of accounts	Deferred tax accounting	Segmental reporting, equity method for investments in associates
DK	Consolidation of accounts	Segmental reporting	Accounting for leases
RK	Consolidation of accounts	Related party transactions	
YM	Consolidation of accounts	Deferred tax accounting	
TM	Consolidation of accounts	Segmental reporting	Deferred tax accounting
DM	Consolidation of accounts	Revenue from discontinued	
		Operations disclosed separately	
PN	Deferred tax accounting	Consolidation of accounts	
AP	Off balance sheet financing	Consolidation of accounts	

[1] Auditor respondents were asked, 'Which specific provisions in US or UK GAAP might usefully be introduced in India so as to provide a more accurate picture of the profitability and true financial worth of companies?'.

Governance of the private sector: regulatory issues

The rules that govern the Indian manufacturing industry changed rapidly through the 1990s. Licensing norms were relaxed, freeing investment controls on investment choices and plant capacities; areas reserved for the public sector were opened up for private investment; restrictions on the concentration of capital were repealed; most sectors were opened up for foreign investment; tariff barriers were lowered and quantitative restrictions were progressively lifted, changing the face of many product markets; the economy was opened to foreign portfolio investments and Indian firms were allowed to raise money and sell equity overseas. Alongside these changes, the rules that govern financial markets were also modified radically as the recommendations of the Committee on the Financial System (Narasimhan Committee I) were implemented, bringing about radical changes in the money market while the administrative machinery that directed the capital market was replaced by an independent regulator. All these changes have meant higher degrees of freedom for the private sector. With government no longer a party to the investment decisions of the private sector, the quality of governance in private companies becomes an issue of concern.

Concerns relating to the quality of corporate governance in the private sector have always been an issue in the public mind. The stock market scam of the early 1990s served to highlight the importance of issues of governance, accountability and transparency. Discussions of the scam, however, limited themselves primarily to the role of banks, brokers and other intermediaries. The battle for control over ITC between the company's management and its largest minority shareholder (and one-time parent), BAT, raised several issues and brought into sharp focus corporate practices in the Indian private sector. From about mid-1994 on, ITC was in the eye of a storm, following the announcement of a generous bonus issue by its management which was seen, by BAT, as a move to raise the cost for majority control. It was two years before ITC dropped off the front pages, by which time it was defending charges of foreign exchange violation. For that short period of time, the ITC saga brought to the fore questions of management accountability, effective board control in financial matters and the role of development financial institutions (DFIs) and their nominee directors on company boards. It also brought to light the fears of the Indian business community, which feared that this might be seen as an opportunity for government to exercise greater control1 over the private sector. The ITC episode, however, was not the only corporate scandal of the 1990s. There were others brewing all the time. The ones relating to companies such as Shaw Wallace and Modi Rubber have not died down yet.

It was perhaps to limit the damage caused to the reputation of the private sector in what were still early days of liberalisation that the leading representative forum of the Indian private sector, the Confederation of Indian Industry (CII), came out with a code for corporate governance which it titled 'Desirable Corporate Governance: A Code'2. We will address the specific recommendation of this code on the relationship between the private sector and financial institutions later in this note. At this stage, it would suffice to say that the code envisaged a framework of corporate governance as something that was best left to the consciences of companies, their directors and their managements and not one that should be enforced through statute. In so far as the CII Code sought voluntary compliance by private companies, earlier this year it was overridden by the recommendations of the Securities and Exchange Board of India (SEBI) Committee on Corporate Governance. SEBI accepted its Committee's recommendation that the implementation of certain core aspects of corporate governance should be made mandatory though the amendment of the listing agreements3 that publicly listed companies enter into with stock exchanges.

Before we proceed any further, it may be useful to define 'corporate governance'. While there are a variety of definitions of corporate governance in the literature on the subject, they vary widely, based as they are on country experiences and the practice of company law in different countries. One definition that takes on board this variety of experiences describes corporate governance as being concerned 'with giving overall direction to the enterprise, with overseeing and controlling executive actions of management and with satisfying legitimate expectations of accountability and regulation by interests beyond the corporate boundaries'4. A more restricted definition would be 'the process of supervision and control intended to ensure that a company's management acts in accordance with the interests of the shareholders'5. This view is perhaps more in tune with the thinking in Indian industry and that of SEBI.

What follows from the above definitions is that central to all discussions on corporate governance are three sets of inter-relationships: the first is between the board and the management; the second is between the company and its shareholders, and the third involves the role of regulatory authorities and bodies in which are included public regulators such as the capital market regulator, the department of government that co-ordinates corporate affairs as also private regulators such as auditors and stock exchanges. This note will restrict itself to commenting on the nature of the intervention being made for better corporate governance by regulatory authorities through changes in corporate law and the role of development financial institutions as the largest block of shareholders and creditors in large manufacturing companies in the Indian private sector.
This note is divided into four sections. Section 1 deals with some issues of corporate control and ownership in the Indian private sector and will attempt to make a limited qualitative assessment of the state of governance in the private sector6, Section 2 is a commentary on the SEBI recommendations for Corporate Governance, Section 3 looks at some specific issues of corporate law and Section 4 looks at the role of DFIs in financing industry.

1. Company Boards and Control and Ownership in the Indian Private Sector

Boards perform an *oversight function*7, according to a development banker we talked with. A promoter chief executive defined a board in the Indian context as *an ombudsman that ensure(s) no conflict arises between owner directors and other shareholders.* A well-known professional director views the board as having the specific functions of *audit,* *which is to ensure that people's funds are deployed adequately and they are safely deployed; personnel, that people are remunerated well so that you get good quality managers and there is a succession plan, therefore you get good quality management planned over a period of years; and thirdly,* [that of looking] *at the strategic programme of the executive management and how that is being implemented.*. Another felt that effective *deliberations of the audit committee, the deliberations of the remuneration and the nominations committees, the deliberations of the board committee on ethics and the deliberations of the board committee on strategy and governance - revealing the outcome of these deliberations - leads to transparency*, making the space for an effective board. Although the foregoing represent diverse views on corporate governance, the common thread that runs through them is that of accountability of boards as being of central importance to corporate governance.

In order to ascertain the quality of boards, we asked companies8 how their board members were selected, what the composition of their boards was, how frequently their boards met and how long their board meetings lasted. At a secondary level, we attempted to assess what management inputs went into preparing papers for board meetings, whether there was a management committee and how it interfaced with the board and what, if any, management decisions or recommendations, in the recent past, had been queried by the board. We saw these questions as means for understanding how effective the control that boards exercise over companies are. While these aspects of our survey have not yet been fully quantified, it is still possible to make some observations on the quality of boards based on a prima facie analysis of our information.

In a majority of the companies in our sample, we found that the choice of directors was the exclusive right of the 'promoter' - even though some promoters did couch this admission/declaration with the statement that the final decision of appointing a director is made by the full board; that boards meet the statutorily required 4 (perhaps 5) times a year, that board meetings typically last less than two hours9, with about 25 percent of the time being devoted to signing board resolutions that are required for various statutory clearances. On the second set of questions, we found that in a majority of the cases, the company's secretarial department was the only part of the company that had any involvement with the preparation of board papers and that management committees, where they did exist, had a limited interface with the board. The response to the last question in many cases was non-conclusive. Speaking on behalf of a respondent company, a senior executive seemed to summarise the general situation of the majority trend in our sample when he said, [Our outside] *directors have very little role to play ... there is a unity of command. Our board meetings last 30 minutes. The company is management-driven rather than board-driven.*

We did find a minority of companies in our sample, about 25 percent10, that did not conform to the foregoing trend but appeared to have developed diligent board procedures and management decision-making institutions that worked in tandem with the board. The managements of these companies were also found to be using their boards as sources for advice and guidance while arriving at strategic decisions. The boards of these companies in general appeared to meet more frequently (at least 8 times a year) and meetings were longer (varying between 4 hours to full day meetings).

While there is no strong evidence to suggest that board practices vary according to ownership, we did find that multinational companies, apart from the odd exception, fall into the first category of companies, with the only difference that these companies go through a variety of compliance rituals that locally-owned firms might not even feel the need to comply with. Also, we found the promoters of these MNCs being represented either by members of the management themselves or by directors who are on the parent's staff. In the case of locally owned companies there is, in the case of many companies in this group, a positive correlation between companies in the second category and DFI involvement on the boards of these companies.

While control of large manufacturing companies can be seen to rest with the 'promoters', be they local or the MNCs who own these firms, one rather outdated estimate11 shows that on an average the DFIs taken together own 23.4 percent of the equity of the top 100 private companies and form the single largest block of votes. In the case of the top ten companies, Bombay Stock Exchange data for 1997-98 shows that DFIs own more than 30 percent of the equity in 7, between 15 percent and 20 percent in two and less than 10 percent in one company. A random search of companies between positions 10 and 100 also shows a roughly similar pattern. There seems to be a general consensus that 'promoter' holdings in companies are low since they simply do not have the money, rates of tax until recently were very high and the restrictions on concentration of capital under the MRTP Act prevented 'promoters' from taking on a controlling stake. One respondent while citing these three reasons also suggested that low holdings were a *hangover from the managing agency system*. There is something in this last view. In most business groups the system of cross-holdings through closely held unlisted and listed firms exists. In the case of many 'promoter' groups this culture of lack of transparency seems to extend beyond just equity funds, wherein the lines between an individual's funds and a public company's funds become indistinguishable. In and of itself, there is nothing wrong with the leveraging of 'own' funds with equity funds from the market to finance growth. The issue of ownership gains significance in a situation in which the extent of the 'promoter' group's financial involvement (equity holdings) is not transparent and the company's business practices are questionable. Even so, some promoter groups have, through the 1990s, attempted to untangle their cross-holdings12 and in many more cases shore up their holdings under the fear of takeover. MNCs, in contrast, are not threatened by possibility of hostile takeovers. This is because a majority of MNC parent companies control their Indian associates through majority equity holding. It, however, needs to be kept in mind that this was not the case, apart from a few exceptions, until 1991. Until 1991 MNCs were required13 to have foreign equity of less than 40 percent. This was changed in 1991 when MNCs already operating in the country were allowed to raise their equity to 51 percent through underpriced preferential share issues14 making it attractive for MNCs to gain majority control. It was then argued by a section of India business that came to be known as the 'Bombay Club' that domestic promoters were not allowed an equally attractive option to raise their equity resulting in an ‘unlevel’ ‘playing field’ between Indian promoters and MNCs.

2. A Commentary on some aspects of the SEBI Recommendations

Many of our respondents have expressed some disquiet with the state of affairs on Indian boards. Reform of corporate governance, many of these respondents have observed, must begin with the boardroom. This emphasis on boardroom reform is clearly shared by a larger group that includes those who are influential both in industry and public policy. The CII notes that ‘the key to good governance is a well functioning board of directors. The board should have ... excellent ... non-executive directors who understand their dual role: of appreciating the issues put forward by management, and of honestly discharging their fiduciary responsibilities towards the company’s shareholders as well as creditors’15. Rather more elaborately, the SEBI Committee on corporate governance comments: ‘the pivotal role in any system of corporate governance is performed by the board of directors. It is accountable to the shareholders and it directs and controls the management. It stewards the company, sets its strategic aims and financial goals and oversees their implementation, puts in place adequate internal controls and periodically reports the activities and progress of the company to its shareholders’ 16.

Beyond outlining the role of the board, the SEBI Committee also discusses the composition of boards. Although at the start of its work, the SEBI committee notes that while it has looked at the experience of corporate governance codes elsewhere, it has sought ‘to prepare a code to suit the Indian corporate environment, as corporate governance frameworks are not exportable’ 17, on the issue of board-room composition, it would appear that the SEBI Committee has considered that an import is warranted. It recommends that the board of a company have an optimum combination of executive and non-executive directors with not less than 50 percent of the board comprising non-executive directors’18. The strong recommendation made by the SEBI Committee that boards have a majority of non-executive directors, for instance, really forms the centrepiece of the recommendations of the Cadbury Committee in the United Kingdom. The shadow of the Cadbury Committee can be seen to be leading the debate on corporate governance, especially amongst industry circles, in India. In the United Kingdom, for some three decades now, discussions about board composition are dominated by the shift in control of companies from shareholders to professional managers19. The Cadbury recommendations need to be seen in this context. The pattern of control over firms in India is somewhat different. Of the top 100 listed manufacturing firms in India, 75 are controlled by business families20. On the composition of the board, our sample of 44 large private manufacturing firms reveals that 70 percent of directors in these companies are non-executive. A study of the top 10 manufacturing firms brings out almost identical results. This does leave open the question of whether codes of governance in use in the Anglo-American world are at all relevant for the Indian experience.

It fact, in some of the manufacturing companies that are within the top 100, we found that there was not even a single executive member on the board. While all these companies have ‘designated managers’ under the Companies Act, 1956, the very fact that such a position persists in some of the largest manufacturing companies is further indicative of the overarching control that business families have over companies. In such companies the board is a purely superficial appendage, while professional managers exist in positions entirely subordinate to the non-executive business family directors and control is exercised outside the board.

A further SEBI recommendation on the composition of the board is that ‘the number of independent directors would depend on the nature of the chairman of the board. In case a company has a non-executive chairman, at least one-third of the board should comprise of independent directors and in case a company has an executive chairman, at least half the board should be independent’ 21. We shall turn to the issue of independence raised in this recommendation later in this note. For the present, it is important to persist with the distinction between executive and non-executive directors. From SEBI’s foregoing construction, it is not very clear how the presence of an executive or non-executive chairman would affect the composition of the board, should such a chairman be a member of the family that controls the company. The lack of this distinction is likely to be further accentuated in a situation where the chairman (irrespective of whether the position is an executive or a non-executive one) and the managing director are related. Should a position exist wherein a non-executive chairmen and the managing director are related, under SEBI’s Code only a minority of directors need to be independent, while the control of the management and the proceedings of the board would in fact remain in the hands of one business family. There are several instances within our sample where such a situation exists. SEBI possibly understands the nature of corporate control in India better than most. The issue of relatives has been an important feature of corporate law in this country22. Even the generally anti-regulatory Working Group on the Companies Act 1956 (WGCA) recommends the tightening of provisions dealing with relatives in a company23. SEBI, too, has adopted a definition of ‘promoter’ that includes a definition of ‘relative’24.

We now turn to the notion of ‘independence’ mentioned in the foregoing mandatory recommendation for compliance described in the SEBI Code. SEBI defines independent directors as ‘directors who apart from receiving directors’ remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgement of the board may affect their independence of judgement. Further, all pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report’25. The idea of ‘independent’ directors has been central to the Anglo-American notion of corporate governance for nearly a decade. Even in the United Kingdom, where the idea was first introduced as part of the Cadbury Code, there has been considerable debate on how and what ‘independence’ means and how it is achieved, or for that matter, how a board decides when the level of independence is reached and whether at all a single tier-board can contain two classes of directors.

More recently, the exhaustive company law review under way in the UK, while commending the working of the London Stock Exchange's (LSE's) voluntary code, has cautioned against making legislative or mandatory provisions for two classes of non-executive directors within the framework of English company law 26. It was perhaps the failure of the LSE to move forward in this area that led to the company law review in the first place27. Even at home, the WGCA had, while commenting on the important role that is believed to be played by non-executive directors in the United States and the United Kingdom, wondered what 'the two adjectives "independent" and "professional" meant28 A similar question was raised by one of our respondents, who wondered who an *'independent' director might be independent of?* Even SEBI recognises the problem of independent directors when it comments 'till recently, it has been the practice of most of the companies in India to fill the board with representatives of the promoters of the company, and independent directors, if chosen, were also hand-picked, thereby ceasing to be independent. This has undergone a change and increasingly boards comprise the following groups of directors - promoter directors, (promoters being defined by the erstwhile Malegam Committee), executive and non-executive directors, a part of whom are independent'29. Exactly when the foregoing change occured and what motivated this change however is not apparent from SEBI's report.

Reacting to this, one of our respondents wondered, *by the wave of whose hand have once hand-picked directors suddenly become independent?* Another wondered if the power to appoint 'independent' directors should be passed over to the government! Some others of our respondents were less circumspect and felt that this provision was a legal sanction for companies to pack their board with cronies.

SEBI makes it mandatory that a company have an audit committee that comprises of at least three board members, all of them non-executive, and that the majority of this committee - including its chairman - be 'independent'30. The Companies (Second) Amendment Bill 1999 (CSAB)31, in contrast, recommends an audit committee of a similar size, with at least two-thirds of its members being from the non-executive category, leaving open one-third of the places to executive directors; the chairmanship of the committee can be from either category. The proposed inclusion of audit committee provisions in the CSAB deviates from 'best practice', where under the codes recommended by both the Cadbury Committee and the Blue Ribbon Committee, audit committees must be composed of a majority of independent directors and exclusively of non-executive directors. In fact, there are suggestions that the United States Securities and Exchange Commission may consider a provision that the terms of audit committee members may be limited to specified ceilings32.

Compliance under the SEBI code is to be ensured through a Chartered Accountant's certificate. Besides increasing the fees of a company's external auditor under the head 'Certification Work', compliance through this route will at best take the issue of directors' responsibility one step further away from the directors themselves. Besides, are auditors really competent to take responsibility, for instance, for what information goes to the board or is it the full board that must take direct responsibility for the information a company's management provides it? The experience of regulating companies through certification has not exactly been effective under the provisions of the Companies Act. Given a shallow capital market, the incentive for companies to comply with listing agreements are weak. One investment banker we talked to felt that the *SEBI code would help institutionalise bad governance*.

3. Issues of Corporate Law

We now turn the focus of our attention to the reform of corporate law in the form of the Companies Act. We will look at the changes made in the Companies Act so far through an amendment of early 1999, as also some of the amendments that are presently before Parliament. We will also look specifically at the question of change in the laws governing disclosure.

Many of our respondents, especially auditors, commented on the lack of transparency in related party transactions. Under the present laws, companies are not required to report to their shareholders on related party transactions. The disclosure, if any, is left to the auditors, who are required to make a limited comment on whether or not loans taken or granted, or material transfers between related parties or those in which a director may be interested, are 'prejudicial to the company's interest'. In the case of investments, while companies are required to make detailed, itemised disclosures of investments in shares, debentures, bonds, etc., they are not required to disclose specifically if these are investments in companies under the same management or ones in which any director is interested. It is left to shareholders to make assessments or use prior knowledge to ascertain whether or not any investment has been made to a group company or not. Under the earlier dispensation, companies were required to seek government approval if they (1) exceeded the limit imposed on them for making investments or (2) if these were related party transactions33. Under the amendment34, companies have been freed from seeking government permission, and they are now required to seek shareholders' approval only if the limits for inter-corporate loans and investments are exceeded. While this is within the direction of change in general, this amendment to the statute book has not been supported by a corresponding requirement for detailed disclosure.

At this point, it would be worthwhile to go over a brief history of the erstwhile provisions for loans and investments under the Companies Act. The requirement [that government approval be sought for inter-corporate loans and investments made to or in companies under the same management] was introduced through an amendment to the Companies Act in 1960. This amendment was based on the Vivian Bose Commission that was set up to look into the issues arising out of the Dalmia-Sahu Jain financial scandal. In 1997, when the WGCA concluded that 'the Dalmia-Sahu Jain Enquiry Commission of the mid-1950s seems to have fostered a belief that all companies are fountainheads of financial dishonesty', the WGCA, it would appear, overlooked the fact that five business houses from amongst the top 15 business houses in the country were defending charges of 'financial dishonesty' - charges which none of them has yet come clear of. While the WGCA was high on rhetoric on the subject of the need for increased disclosure, when it came to the substance of disclosure on related party transactions, it remained silent. What remains deeply questionable is how the question of disclosure passed the sight of the Department of Company Affairs as well as that of Parliament or any of its standing committees while they were making amendments to the Companies Act. What was once legislation based on the findings and recommendations of a parliamentary committee ended up being repealed through ordinance.

The lack of provisions for disclosures on related party transactions apart, one area where there is relatively little ambiguity about making disclosures in the Companies Act concerns the provisions for a 'scheme of arrangement' that may result in the merger or liquidation of a company. The law clearly sets out that 'with every notice calling the meeting which is sent to a creditor or member, there shall be sent also a statement setting forth the terms of the compromise or arrangement and explaining its effect, and in particular, stating any material interests of the directors ..., whether in their capacity as such or as members or creditors of the company or otherwise, and the effect on those interests, of the compromise or arrangement, if, and in so far as, it is different from the effect on the like interests of other persons'35. All the same, it would appear that where the law has been clear, ambiguities have entered the system through judicial pronouncements on legislative intent and interpretation 36. As a result of these inconsistencies between legislative authority, regulatory bodies and the judiciary, we found that two companies of the same group that were being merged into one entity failed to disclose the substantial increase in the equity holding of the dominant shareholder, who also had management control in both companies. The lack of such disclosures also brings into question the valuation practice employed by auditors, since they are at best based on insufficient information. Instances such as these do bring into focus the role of auditors in matters relating to disclosures. One of our respondents shared with us valuation reports prepared for a merger between two companies by two reputed firms of auditors. Apart from the fact that the texts of the two valuation reports reads more or less the same, the two reports recommend identical share exchange ratios, down to the second decimal. This also leaves open the question of the extent of independence of corporate auditors.

In the case of material transfers between related parties, companies are neither required to seek government permission nor are they required to seek the approval of shareholders, as they are in the case of loans and investments when the stipulated limit for aggregate investments is exceeded. Some respondents from the financial sector expressed concern over the magnitude of intra-group material transfers. One of them pointed out that if these transfers were booked at realistic prices, there could be a sharp drop in the sales of some of the largest manufacturing companies in the country. These transfers, apart from those that involve payments for goods, also include in the case of some groups payments for group services, some of which are completely fictitious. The introduction of consolidation of accounts, also a recommendation of the WGCA, is seen as one possible means of disengaging such related party transactions. Consolidation may not, however, bring the results most observers expect, given the nature of the complex cross-holdings through which companies are controlled. As a result, a large number of companies in a promoter group may remain outside the framework of accounts consolidation.

The structure of cross-holdings also allows some business groups to walk the tightrope between possible violations of the law and being just at the margin of the law. What, then, can be classified as 'companies under the same management' can be a contentious issue open to interpretation37. Clarity on the definition of 'group' companies based on the pattern of firm ownership in Indian remains a gap that needs to be filled before any meaningful debate on consolidation of accounts can proceed.

The one amendment that the SCAB seeks to bring, based on the recommendations of the WGCA, is the repeal of the provisions in the Companies Act 1956 for deemed public companies. The provisions are understood to place limitations on the growth of closely held private companies. Should this amendment go through, there would only be two classes of companies - private ones, which would be largely self-governing, and public listed companies. While in the United Kingdom and the United States, this seems to be the practice, elsewhere the equivalent of a deemed company exists38. The concept of a deemed public company includes a notion of a plurality of interests in a company that goes beyond, or potentially conflicts with, the interests of equity holders where in, despite being a closely held company if it exceeds a critical size it is likely to involve interests of groups other than those of equity holders. Should the foregoing amendment go through, it would narrow down the statute book's understanding of the interests in a company, in particular the interests of creditors. Not just would some large manufacturing companies, in the new environment, operate under less scrutiny, so would the 'holding companies' of large promoter groups. Having said this, the SCAB's introduction of a statement of directors' responsibility39 as a compliance requirement is a step in the right direction, as are the provisions for additional protection for small public deposit holders.

Poor compliance or the misuse of loopholes by private companies or the reliance on one institution of government against another does not take away from the fact that the regulatory mechanism has simply not delivered. The Department of Company Affairs is empowered with extensive powers to obtain information from companies and enquire into their affairs should it apprehend mala fide. Further, the DCA is within its powers to investigate the affairs of companies after obtaining necessary directions from the Company Law Board. The exercise of these provisions could have created an environment of effective deterrence. On both counts, the DCA has been less than successful. Moreover, the DCA has not succeeded in ensuring that companies file with the Registrar of Companies the documents and information that they are required to file in the normal course. The extension to the recent amnesty scheme for companies that are in default of compliance requirements introduced by the DCA suggests that the scheme has been less than successful. This is despite the sharp increase in fines, in relative terms, that would be imposed on non-compliant companies once the SCAB is legislated. This reflects the attitude of companies towards the DCA. As a senior investigator at the DCA complained, *We have limited degrees of freedom*. When another officer was asked why the DCA did not effectively employ its powers of enquiry and investigation, he complained that in a liberalised environment, the DCA *had lost its legislative mandate*.

The DCA's *legislative mandate* is worth looking at. A new Companies Bill was placed before Parliament in the early 1990s. This bill got stuck in a parliamentary committee. In 1996, a new government moved the DCA from the Ministry of Law to the Ministry of Finance and set up the WGCA in 1996. Based on the recommendations of the WGCA, in mid 1997, the government sent a bill to Parliament which was taken up for consideration by the parliamentary standing committee for finance. This bill, as it happens, is in theory still pending before Parliament. In 1998, yet another new government decided that the rightful place for the DCA was indeed the Ministry of Law and hence the parliamentary standing committee for home was assigned the task of examining the provisions of the bill. In late1998, the government decided it was time to take another look at the bill, but also to bring in selective amendments in the meantime. While one lot of amendments - primarily on share buyback, inter-corporate loans and investments and accounting and audit standards - were hammered through an ordinance, a more exhaustive set has remained before a parliamentary committee for almost a year now. Certain Members of Parliament, it would appear, *irrespective of party or ideology, act directly at the behest of business interests both in the lobbies of Parliament and through committees*. One recent battle has been over the DCA recommendation allowing for small shareholders' representation on the boards of companies40. Without going into the merits of this provision41, it may be said that neither the parliamentary standing committee nor the DCA feel the need to put out a clarification in some detail on the rationale underlying the dropping of this provision. It was, ironically, left to a superannuated civil servant to say that *the shroud of secrecy in which legislation is written has to drop*.

4. Development Financial Institutions

In the context of the Indian private sector, DFIs form an important peg in the regulatory framework for better corporate governance. As already discussed, DFIs hold substantial equity positions in large private manufacturing companies. Moreover, public financial institutions (PFIs), investment institutions, and public sector banks (PSBs) together remain the single largest source of corporate finance in India. By virtue of the equity positions that these institutions hold in private companies and through loan covenants that companies enter into with them, the institutions have directors on the boards of very many large companies. Questions about the effectiveness of the institutions at various points over the past decade have resulted in demands for radical reforms.

Many of our respondents - especially professionals such as corporate lawyers, chartered accountants and of course civil servants and members of DFI managements - felt that DFIs *cannot escape the issue of corporate governance... NPAs are a creditors' involvement in bad corporate governance*. NPAs are indeed a problem that can potentially jeopardise the existence of some PFIs and PSBs. The problem of NPAs is largely ascribed to the political pressures that these institutions face. The extent to which these institutions are trapped in the interface between politics and business is still difficult to estimate, although our discussions with senior development bankers and civil servants revealed some details of such pressures in qualitative detail. Pressures by the business class are exercised through the political community in a variety of ways such as influencing appointments to the top positions in these institutions42, political support for industrial projects in particular MPs' constituencies, states, etc., and finally, through the straight and direct demands for privileged access to funds made by particular business houses. Outside of direct political pressures, a dominant view among officials is that they would *rather be safe than sorry*. Several DFI officials also claimed that business houses use the threat of having the officer concerned investigated through the government's vigilance machinery, should the officer not comply. A civil servant with experience of the Central Vigilance Commission confirmed this view and added that a very large number of vigilance cases under investigation are from the financial sector and, further, that many of them are constructed on thin evidence, although given the vigilance procedures, it was difficult to close the enquiries.

Political pressures apart, the DFIs' lending policy is also governed by the pre-1991 economic policy regime. These institutions were created with the aim of meeting the investment needs of rapid industrial growth and supporting nascent industrial enterprises by handing out concessional medium and long-term project finance. These institutions were recipients of cheap funds funnelled to them through the banking sector which they, in turn, passed on to industry at concessional rates. As one development banker described it, *When someone came to you with an industrial licence under government policy, he was de facto eligible to project finance*. Under the post-1991 economic regime, with many recommendations of the Narasimhan Committee - particularly those concerning operating procedures and accounting practices - being implemented, bank deposits dried up, making it necessary for financial institutions to compete for retail and other sources of funds like any other operator in the financial sector43.

Financial institutions have been reasonably successful in making the transition as far as resource mobilisation is concerned. While it is not possible prima facie to question the lending or project appraisal practices of financial institutions, one DFI observer did note that there were several projects in the same industry cleared by one DFI in the recent past that had sharply diverging unit project costs. A member of a DFI's top management conceded that industry and product market databases were weak and this could result in appraisal errors. A retired development banker also felt that DFIs relied far too much on the name of the 'promoter' and did not have any mechanism or procedures for effectively evaluating the management capabilities of a particular 'promoter', especially when the investment was in an industrial sector that was new for the 'promoter'.

The persisting problem with DFIs appears to be that they monitor their loans and investments inadequately, make decisions slowly, and find it very difficult to implement decisions, particularly when they involve strong measures against a recalcitrant company. Tracing the histories of DFI behaviour in a large number of cases of companies under the purview of SICA / BIFR, we found that DFIs react to adverse changes in the companies they are involved in just that bit too late to salvage these companies, even under the extremely permissive law as it stands. In many cases, we found that detailed and lengthy letters seeking information were sent by the DFIs to errant companies and that when these letters went unanswered, all that resulted were reminders that were sent after gaps as long as three months. This is despite the fact that DFIs, through loan covenants that debtor companies have to sign, not only enjoy complete rights to information and the appointment of nominee directors, but also the right to intervene in the appointment of and the functioning of managements and the right to convert loans into equity. Even in the event of the corporate mergers of companies that directly alter the rights of debt and equity holders - and companies are required to obtain special approvals for this from the DFIs - it would appear that DFIs issue these approvals, with some exceptions, as a matter of course. On the issue of corporate mergers, a member of a DFI's top management argued: *How can we evaluate every investment, we have investments in 6000 different securities?44*

The recovery of loans through the foreclosure route and the conversion of debt into equity are subjects of contentious judicial issues; DFIs are not even seen to be exercising the provisions they are empowered with at earlier stages in the possible chain of actions open to them. In the celebrated case of Modi Rubber, DFIs have still not succeeded in divesting their equity holdings and collecting their loans in a saga, going by newspaper reports, that has gone on for five years. While some of these DFI practices can be attributed to political and bureaucratic pressures, the DFI bureaucracy and management cannot completely escape the question of responsibility.

DFI policy is also, to some extent, vitiated by the dual centres of authority. While on the one hand, the Reserve Bank of India, as monetary policy authority is meant to regulate the conduct of DFIs, the Union Ministry of Finance, as the national economic policy maker and the ministry of the government that strictly owns the DFIs (therefore being responsible for appointments, etc., in its capacity as sole or majority shareholder) also issues directives46. These dual centres of power, along with the rather secretive manner in which DFI conduct is governed, leaves much to be desired, since DFI policy is understood through a series of rumours and press leaks that create an environment in which DFIs need not feel completely accountable or experience the pressure to conduct their affairs transparently.

The foregoing impression of the DFIs is also an issue for the private sector, since according to one articulate view, for these 'informed insiders...corporate governance and careful monitoring do not happen as they are supposed to when a stakeholder is both creditor and owner of equity. The apparent failure of government controlled DFIs to monitor companies in their dual capacities as major creditors and shareholders has much to do with a pervasive anti-incentive structure... Consequently, the institutions which could have played the most provocative role in corporate governance - India's largest shareholders-cum-debt-holders - have not done so. The long term solution requires questioning the very basis of majority government ownership of the DFIs, and whether it augurs for better governance and higher shareholder value for India's companies as well as for the DFIs themselves'47. While some of the institutional problems of DFIs are valid this position seems to be rather one-sided in ignoring the role played by the DFI creditors48. Besides the role of the DFIs, the issue of their nominee directors has been contentious. In 1998, when there was a suggestion that UTI would appoint directors on the boards of companies where it had a significant equity stake, there was some amount of discomfort amongst private sector managements. This DFI reaction perhaps came in response to the

CII recommendation that DFIs exercise restraint in appointing nominee directors ‘except in the event of serious and systematic debt default’. In the case of equity investments, the CII recommended that DFIs should have nominees only where it has an equity stake in excess of five percent or where all DFIs together have a stake in excess of 10 percent. SEBI’s report on corporate governance, when released as a draft, recommended the withdrawal of DFI nominees in those companies where the DFIs held equity positions since such directors and, therefore, the DFIs, would be ‘privy to price sensitive information’. In the final report, SEBI made a non-mandatory recommendation for restraint along lines similar to that made by CII and recommended, in the case of equity investments, that DFI nominees should have the same status as any other director of the company in their responsibility towards shareholders of the company and that DFIs should exercise diligence by creating ‘Chinese walls’ between their departments monitoring companies and those managing equities. At present, nominees of some DFIs enjoy legislative protection 49. This is a contentious point, since some sections of the business community argue that there is no provision in the Companies Act for two classes of directors. DFIs, on the other hand, claim that the protection their nominees enjoy is extremely limited and open to judicial interpretation. A legal opinion obtained by the Industrial Development Bank of India (IDBI) suggests that ‘the liability of the directors of a company being joint and several under the Companies Act 1956 the directors of a company, including a nominee director, can be prosecuted for any default, non-compliance, failure, refusal, or contravention if it can be proved that the concerned directors had been guilty knowingly or wilfully’50. This apart, the position of protected nominee directors obtains only where such directors are appointed to monitor loans. In cases where DFIs or the investment institutions have directors on boards of companies by virtue of the equity they hold in companies the DFI /investment institution directors are elected through the same route as all other directors and enjoy the same rights and responsibilities as all other directors.

The presence of DFI nominees on company boards is also resisted because appointees are seen to be lacking in the time they need in order to be effective directors, or as being disinterested if not simply incompetent. This view was strongly questioned by many professionals who are present in their individual capacities on the boards of companies. One of them observed that *it was the presence of DFI nominees that ensured that board meetings were held, agenda papers were prepared...*A very senior corporate lawyer said that he would be hard put to *raise issues at board meetings without the support of the institutional nominee*. There was a consensus amongst professionals on the boards of companies around this view. Other respondents brought to light the fact that many of the practices that are seen as the ‘best practices’ and are already in force in many OECD economies, especially the United States and the United Kingdom, such as board audit committees, were introduced to Indian boards by the DFIs. The Managing Director of one of the first companies to introduce an audit committee confirmed that it was done at the suggestion of the DFI nominee. Managing Directors of what are possibly the two most respected capital goods manufacturers in the country who agreed to be respondents shared in great detail information about how DFI nominees had played crucial roles in helping the companies they headed define their growth and restructuring objectives in the 1990s.

None of this should, however, suggest that the role of DFI nominees does not need to be reviewed and perhaps reformed. All the same, it needs to be done in an atmosphere that promotes debate around critical issues and not one dominated by a series of partisan assertions.

The position of the DFIs in the Indian context remains unassailable. Their ability to tap private household savings51 continues to far exceed any other group of players within the financial sector or investment location. The publicly owned DFIs - PFIs, IIs and the PSBs - remain the largest recipients of household savings52 . The role that some sections of the Indian private sector envisaged for the capital market in tapping household savings based on the experience of the second half of the 1980s did not materialise, perhaps because of the scandal that was associated with the secondary market in the early 1990s, and the scandal related to the primary market in the mid-1990s53. Even these booms, however, were largely financed by the DFIs. Although one company's managing director said to us: *they (DFIs) have no role to play, when I can borrow in London at 200 base points below the PLR54*. Not everyone shares this confidence: 'IDBI, ICICI, IFCI... will...periodically come to the market with 15 percent to 16 percent bonds. Such a high yield on what is effectively a risk-free instrument will put an upper bound to the demand for relatively more risky equity'55. Further, since data is now becoming available for the decade of the 1990s, there is evidence to suggest a decline in the rate of savings between 1990-96, when compared with the past decade and therefore a decline in the availability of internal accruals as a source of funds for investment in the private corporate sector56. This, taken along with the decline of equity financing and the inherent limitations and weaknesses of the capital market in India57, particularly in the second half of the 1990s, leaves the private corporate sector with a limited set of options for sources of funds.

5. Recommendations

The problem of corporate governance in the Indian private sector companies needs to be understood on the basis of the practices that obtain within the private sector. The problem can be summarised as the privileging of the interests of one particular group over all others interests in a company. Unhealthy practices in the private sector have benefited from the inability of regulatory bodies to create a clear set of rules just as much as the private sector has been influential in hampering the implementation of the regulation as it exists. In the case of corporate law there are ambiguities in the law, parallel and often competing regulatory bodies and significant failures even where the law is straightforward. In the case of development financial institutions too there are dual centres of authority, inconsistencies in lending and investment practices and the near absence of diligent recovery procedures even when pushing some of these institutions to the brink of collapse. In this context the minimal agenda for corporate reform is a legislative initiative that puts in place:

- rules that place corporate responsibility on a company’s board of directors that act as effective deterrents for corporate mala fide;
- norms for disclosure that adequately deal with issues relating to inter-corporate financial flows and related party transactions;
- clear rules that define the role and powers of regulatory bodies;
- an effective framework for regulating the private corporate sector on financial matters that takes on board the experience of failure of existing policy, and
- organisational autonomy that allows DFIs to pursue their fiduciary powers and be freed from political interference in their routine lending and investment operations.

While some legislative changes have already been and others are on the cards they are as discussed in sections 2 and 3 above are at best limited in reach and piecemeal in nature. The new rules, rather like the old ones, are vague, continue to have loopholes and are subject to interpretation. In short, they leave room for violation. Therefore, the principal change that needs to precede any other is a transparent machinery for policy making which then puts in the public space who is seeking what rather than one or another sectional interest driving public policy. Since the medium and long-term sustainability of large companies in India, as any where else, will be determined by a range of interests that involve not just equity-holders but go beyond them to include the exchequer, creditors, workers, technology, innovation, society and the environment. These ‘interests’ are outside the remit of the present study. All the same, the manner in which these concerns are addressed will depend on how the responses to the issues raised in this study are addressed.

References

[1] There were a series of press reports on this at the time, particularly in response to alleged press leaks of the Government of India's Ministry of Finance communications to the DFIs.

[2] CII [1997].

[3] SEBI [2000] letter of 21 February 2000 to all stock exchanges.

[4] R. I. Tricker, *Corporate Governance: Practice, Procedures and Powers in British Companies and their Board of Directors* (1984) p. 6, cited J. E. Parkinson, *Corporate Power and Responsibility* (Oxford, 1993) .

[5] Parkinson, *Corporate Power and Responsibility*, p. 159.

[6] See the previous report by Banaji.

[7] Quotations from transcripts of interviews with respondents in our study are in italics. The names of the respondents are withheld since all respondents were assured complete confidentiality.

[8] Forty-four companies responded to our survey, and the following discussion is based on an analysis of their responses. This 'core' sample was chosen from the 150 largest publicly listed manufacturing companies in the country. Two companies from within the service sector were also included, since they were seen as important participants in the debate on corporate governance within industry associations. All the companies in the core sample are market leaders (within the top three within their product markets) which we see as a barometer of competitiveness. Finally, within the sample are included companies that have, between them, accessed the whole variety of sources for corporate investment available to private sector companies in India.

[9] This appears to go well beyond our sample, going by newspaper notices of quarterly financial disclosures made by companies in some business groups, where several companies of the same group announce their date of record as the same. Since the promoter directors are common in all these companies no board meeting could last more than a couple of hours.

[10] We have, however, wondered if this sample overestimates companies that fall into this category, since a very large number of companies that would possibly fall into the first category did not respond to our survey.

[11] CMIE [1994].

[12] Where the sale of shares involves a public company divesting its holdings in another group public company in favour of a group holding company, then the divesting company is effectively parting with a share of the controlling interest of the other company. The price the share should attract ought to be a premium price. This issue appears to have slipped public attention, since most of this disentangling of cross-holdings has happened under the protection of the creeping acquisitions provisions of the SEBI Takeover Code.

[13] Under provisions of the Foreign Exchange Regulation Act 1973

[14] Through a notification issued by the Controller of Capital Issues, Ministry of Finance, Government of India on 27 November 1991.

[15] CII [1997].

[16] SEBI [2000]a, *Report of the Committee Appointed on Corporate Governance*, 2.8. For a more detailed description see 6.1 and 6.2.

[17] SEBI [2000]a, 2.6.

[18] SEBI [2000]a, 6.9.

[19] E. S. Herman, *Corporate Control, Corporate Power* (Cambridge, 1981).

[20] The top hundred have been selected on the basis of net sales, rather than market capitalisation, since the former is a better reflection of a company's size and the multiple interests involved in it. The data used is from *Business Standard's* BS-1000 listing of February 2000. The 25 non-promoter companies include 19 MNCs and 6 that can be described as being controlled by professional managers. Companies in which the Government of India continues to hold a majority stake have been excluded from this list.

[21] SEBI [2000]a, 6.9.

[22] Companies Act 1956, Meaning of Relative, sec. 6. This clause has been tightened through several amendments over the years.

[23] RWGCA[1997] - Report of the Working Group on the Companies Act 1956 - 4.5, 4.6.

24SEBI [1995] - Malegam Committee Report on Disclosure Requirements in Offer Documents.
25SEBI [2000]a, 6.5.
26Department of Trade and Industry, UK, *Modern Company Law For A Competitive Economy: Developing a Framework*, Vol 5 (March 2000), pp. 71-73.
27A. Dignam, 'A Principled Approach to Self-Regulation?' *The Company Lawyer* 19 (1998) 140 ff.
28WGCA [1997], 4.3.
29SEBI [2000]a, 6.4.
30SEBI [2000]a, 9.6.
31CSAB [1999] - Companies (Second) Amendment Bill - sec 134.
32Pricewaterhouse Coopers, *Audit Practices: Good Practices for Meeting Market Expectations* (1999), p. 21.
33Companies Act 1956, sec 370 and 372.
34Companies (Amendment) Act 1999, sec 19.
35Companies Act 1956 (393)(1)(a).
36See: HLEU v/s HLL, M. Mafatlal v/s Mafatlal Industries, both orders of the Supreme Court.
37In the case of one promoter group that grew rapidly during the 1990s, we found that there was a complex structure of cross-holdings, not just in the case of the listed companies but also in the case of the closely held investment companies. Furthermore, no member of the promoter family is a director of any of the investment companies. Directors of these companies are executives within the group and a high turnover of these directors is maintained.
38J. Kay and A. Silberston, Corporate Governance, *National Institute Economic Review*, August 1995, especially on deemed company equivalents in France and Germany.
39For an excellent exposition, cf. the following: 'The fact that directors are fiduciaries imposes on them (1) subjective duties of honesty and good faith, and (2) objective duties not to place themselves in a position where their duties might conflict with their private interests. Each of these can be sub-divided into four general principles: first, directors must act bona fide, that is in what they believe to be in the interest of the company. Secondly, they must exercise their powers for the particular purpose for which they were conferred and not some extraneous purpose even though they honestly believe that to be in the best interest of the company. Thirdly, they must not fetter their discretion to exercise their powers from time to time in accordance with the foregoing rules, and fourthly, despite compliance with the foregoing rules, they must not without the compliance of the company place themselves in a position where there is a conflict between their duties and their personal interest' [*Gower's Principles of Modern Company Law*, 4th edn, p. 576f. - from 1822]
40SCAB 1999, sec 122.
41Although we have a senior corporate lawyer among our respondents who thought this was the way to go and that a similar provision had worked wonders in Pakistan.
42Even as this note was being written, there was a 'Tussle for the top job at LIC', *Times of India*, 8th September 2000.
43For an excellent exposition on the impact of the reform of the financial sector on industry, see Khanna, 'Financial Reforms and the Industrial Sector in India', *Economic and Political Weekly*, 6 November, 1999.
44This issue is however the subject of some scrutiny. A note of the Ministry of Finance says: 'Existing practices and procedures followed by institutions for examining merger proposals do not adequately take into account the modalities of mergers adopted by promoters, such as formation of subsidiaries, grant of interest free or concessional loans to subsidiaries / associate companies for purchasing of shares in merging companies, purchase of shares of merging companies at less than the market value, subsequent desubsidiarisation of merging companies, and in the process, increase in the shareholding and control by promoters in the merged company' - 'DFIs put on M&A Vigil', *Economic Times*, 30 December 1997.
45In the case of a demerger concerning one company we found that the management had not even obtained a valuation report for the share-transfer-ratio and the DFIs were silent. The absence of the valuation report was brought to book by a group of minority shareholders.
46One of many instances of this is 'RBI asks DFIs to check funds flow from corporates to subsidiaries' - *Economic Times*, 20 February 2000, to be seen in conjunction with the report appearing in the same newspaper less than two months earlier quoted in note 44 above.

47CII [1997], p. 8f.

48It would be a trifle churlish to recount the details of the events around the release and subsequent withdrawal of the CII report on public sector banks last winter.

49IDBI's nominee directors enjoy protection under section 30A of the IDBI Act 1964; similar provisions also exist under the IFC Act.

50Industrial Development Bank of India [1986] Guidelines for Nominee Directors, p14

51Household savings constitute over 80% of total private savings through the 1990s and therefore remain the largest source of corporate finance. There is little to suggest that this will change in the near future.

52K. Nagraj, 'India's Capital Market Growth', *EPW* Special Number, 1996

53P. J. Nayak, 'Regulation and Market Microstructure', in J. A. Hansen and Sanjay Kathuria, eds., *India: A Financial Sector for the Twenty-First Century* (New Delhi, 1999) 266ff.

54Although some companies have been successful in raising funds through GDRs, ADRs and non-equity linked bonds and loans. But going by the experience of Indian companies raising GDRs, it may not be prudent to consider these as sustainable sources of funds as yet.

55CII [1997] p.10 - although this comment was made in April 1997 and nominal rates of interest may have declined sharply, the sentiment remains the same.

56Mathew Joseph, et al., 'Financing of Indian Firms', in Hansen and Kathuria, *A Financial Sector for the Twenty-First Century*.

57It is useful to stress here that internal accruals and debt are perceived to be the sources of finance and the source of long-term stability for firms within the OECD, and conversely that excessive dependence on equity as a source of finance lends a higher degree of instability in a market such as India, see Ajit Singh, 'Liberalisation, the Stock Market and the Market for Corporate Control', in Isher Judge Ahluwalia and I. M. Little, eds., *India's Economic Reforms and Development* (New Delhi, 1998); Ha-Joon Chang, et al., 'Interpreting the Korean Crises', in *Cambridge Journal of Economics* 22 (1998), makes a case for uncontrolled financial liberalisation as a major source for the economic crises in South Korea.

List of respondents interviewed between April 1998 and January20001

Albert Aboody	KPMG Peat Marwick
Rajkumar Advani	A. F. Ferguson & Co
Vijay C. Advani	Templeton Asset Management
Prabodh Agarwal	Credit Lyonnais Securities India
Gagan Ahluwalia	Dabur India
Mani Aiyar	K.S. Aiyar & Co.
M. A. Alagappan	**MurugappaGroup**
Samir Arora	Alliance Capital Asset Management
K. N. Atmaramani	Tata Asset Management
Rajeev Bakshi	**Cadbury India**
R. Balakrishnan	Srei International Finance
P. Balasubramanian	Life Insurance Corporation of India
Shumeet Banerji	Booz Allen & Hamilton
Debashis Basu	journalist and consultant
Debabrata Bhadury	**Hoechst Marion Roussel**
M. L. Bhakta	Kanga & Co.
Vimal Bhandari	Infrastructure Leasing & Financial Services
Vallabh Bhansali	Enam Financial Consultants
K. R. Bharat	Credit Suisse First Boston (India) Securities
U.R. Bhat	Jardine Fleming India Asset Management
Jaimin Bhatt	Kotak Mahindra Capital Company
C. B. Bhave	National Securities Depository Ltd.
Udayan Bose	Lazard Creditcapital India
Shaun Browne	HSBC Capital Markets
Rosanagh Catherwood	Dewe Rogerson
Sujit Chandran	GIC Asset Management Co.
S. Chandrashekhar	IDBI Investment Management Co.
Kishor Chaukar	ICICI Securities and Finance (I-Sec)
Ashok Chhabra	**Procter & Gamble**
M. Chitale	Mukund M Chitale & Co.
R. P. Chitale	M. P. Chitale & Co.
Dileep C. Choksi	Deloitte Haskins & Sells
John Clarke	ABB
K. B. Dadiseth	**Hindustan Lever**
B. G. Daga	Unit Trust of India
Ashish Dalal	Dalal & Shah
Sucheta Dalal	financial journalist
S. M. Datta	Castrol India
E. B. Desai	Mulla & Mulla & Craigie Blunt & Caroe
Ridham Desai	JM Morgan Stanley Securities
Xerxes Desai	**Titan Industries**

N. M. Dhuldhoya	**National Organic Chemical Industries**
Pradeep Dokania	DSP Merrill Lynch
Bharat Doshi	**Mahindra & Mahindra**
Bennet D’Costa	Hindustan Lever Employees’ Union
Moses A. Elias	**Colgate-Palmolive**
Arun Gandhi	N.M. Raiji & Co.
Dr Ashok Ganguly	ICI India
H. A. Ghanekar	Crompton Greaves
Amit Ghose	Credit Lyonnais Securities India
R. Gopalakrishnan	Tata Sons
Dr L. C. Gupta	Society for Capital Market Research and Dev.
Y. P. Gupta	Life Insurance Corporation of India
Y. K. Hamied	**Cipla**
Shailesh Haribhakti	Moores Rowland Consulting
Hemindra Hazari	ASK-Raymond James
Rabindra Hazari	Advocate
Simon Holdsworth	ITC Threadneedle
Ishaat Hussain	Tata Sons
J. J. Irani	**Tata Iron & Steel Co.**
N. Jajodia	Central Depository Services
A. J. S Jhala	**Hindalco Industries**
A. Jhunjhunwala	**Reliance Industries**
Ulhas Joglekar	N.M. Raiji & Co.
Y. M. Kale	A. F. Ferguson
Dinesh Kanabar	RSM & Co.
K. Kannan	**Bank of Baroda**
M. B. Kapadia	Glaxo Wellcome
Rajesh Kapadia	Kapadia Associates
Pratip Kar	Securities & Exchange Board of India
D. A. Kasargod	SBI Funds Management
Nitin Kasliwal	**S. Kumar’s Synfabs**
K. K. Kaura	**ABB**
Ajay Kaushal	Arthur Andersen
S. H. Khan	Credit Analysis & Research (CARE)
B. K. Khare	B. K. Khare & Co.
H. F. Khorakiwala	**Wockhardt**
N. D. Khurody	**Voltas**
H. R. Khusrokhan	**Glaxo Wellcome**
Divya Krishnan	SBI Mutual Fund
E. A. Kshirsagar	A. F. Ferguson & Co.
S. D. Kulkarni	**Larsen & Toubro**
Brijmohan Lall	**Hero Honda Motors**
Euan Macdonald	Warburg Dillon Read
Keshub Mahindra	**Mahindra & Mahindra**
P. V. Maiya	ICICI Banking Corporation

Y. H. Malegam	S. B. Billimoria & Co.
Nandan Maluste	Kotak Mahindra Finance
Harsh Mariwala	**Marico Industries**
Thomas Mathew	Lovelock & Lewes
Bansi S. Mehta	Bansi S. Mehta & Co.
Dr. F. A. Mehta	Forbes Group
Bhadresh Modi	GIC Asset Management Co.
Nachiket Mor	ICICI
S. Mukherji	ICICI
N. R. Narayana Murthy	**Infosys Technologies**
Daraius Z. Musa	Ernst & Young
S. Naganath	DSP Merrill Lynch Asset Management
T. M. M. Nambiar	**Associated Cement Companies (ACC)**
K. C. Narang	Paper Products
P. D. Narang	**Dabur India**
Aditya Narayan	**ICI India**
L. K. Narayan	Infrastructure Development Finance Co.
P. A. Narvekar	B. K. Khare & Co.
P. R. Naware	**The Great Eastern Shipping Co.**
Mr Niamatullah	SBI Funds Management
K. K. Nohria	**Crompton Greaves**
Mukesh Palta	**Castrol India**
R. M. Pandia	**Herdillia Chemicals**
Premal Parekh	Price Waterhouse Coopers
Ameet Parikh	Arthur Andersen
Parag Parikh	Parag Parikh Financial Advisory Services
Vinay Parikh	**Piramal Enterprises**
Dr. R. H. Patil	National Stock Exchange of India
A. Prakash	Morgan Stanley Asset Management
S.V. Prasad	J. M. Capital Management
V. Rai	**Rallis India**
K. Rajagopalachari	**Asian Paints**
K. Ramachandran	**Philips India**
G. K. Raman	Sundaram Finance
T. P. Raman	Sundaram Newton Asset Management Co.
K. S. Ramchandran	Smith & Nephew Medical
S. Rangarajan	Rangarajan & Prabhakaran (Advocates), Chennai
Dr K. Kameswara Rao	Industrial Development Bank of India
Bharat S. Raut	Bharat S. Raut & Co.
D. N. Raval	Securities & Exchange Board of India (SEBI)
R. Ravimohan	The Credit Rating Information Services of India
J. S. Remedios	**Madura Coats**
S. Samuel	**Ceat**
M. P. Saranath	**Novartis India**
M. Sarwate	Marico Industries

C. Sampat	Individual investor
Narotam Sekhsaria	**Gujarat Ambuja Cements**
Dr. Basudeb Sen	Unit Trust of India
Narayan K. Seshadri	Arthur Andersen
Sunil Seth	Indosuez W. I. Carr Securities
Bharat Shah	Birla Capital International AMC
Bipin Shah	Indus Venture Management
Nilesh K. Shah	Colgate-Palmolive
Pradip P. Shah	IndAsia Fund Advisors
R. A. Shah	Crawford Bayley & Co.
Rajesh Shah	A. B. Modi & Associates
Rajiv Shah	A. F. Ferguson & Co.
R. V. Shahi	**BSES**
M. K. Sharma	**Hindustan Lever**
R. G. Sharma	LIC Mutual Fund
Shankar Sharma	First Global
B. S. Shashidar	InvestSmart India
Cyril S. Shroff	Amarchand & Mangaldas & Suresh A Shroff & Co.
A. P. Singh	ICICI
T. Dulip Singh	King & Partridge (Solicitors), Chennai
Ajay Srinivasan	Prudential ICICI Asset Management
N. Srinivasan	Fraser & Ross/Deloitte, Haskins & Sells
V. S. Srinivasan	20th Century Finance Corporation
A. Srivastava	Aditya Birla Group
R. Subrahmanian	Hoechst Marion Roussel
P. S. Subramanyam	Unit Trust of India
U. Sundararajan	Bharat Petroleum Corporation
N. Tandon	Citigate Dewe Rogerson
H. J .Tavaria	Merind
Gul Tekchandani	SUN F&C Asset Management
Vijay Thacker	V. P. Thacker & Co
D. Thankappan	Kamani Employees' Union
Gautam Thapar	**Ballarpur Industries**
L. M. Thapar	Thapar Group
Kishore Udiaver	GIC Asset Management Co.
N. Vaghul	ICICI
S. Venkitaramanan	Reserve Bank of India
M. S. Verma	Reserve Bank of India and IDBI Bank
A. Warerkar	GTN Textiles
Ian R. Young	**Pfizer**