Part 1

Corporate Governance and Corporate Law Reform in India

Introduction

Corporate governance basically denotes rule of law, transparency, accountability and protection of public interest in the management of a company's affairs in the prevailing global, competitive and digital environment. It calls for an enlightened investing community and strict regulatory regimes to protect the rights of the investors and companies to improve productivity and profitability without recourse to any means which will offend the moral, ethical and regulatory framework.

The framework for corporate governance is not only an important component affecting the long-term prosperity of companies, but it is a leading species of large genus namely, National Governance, Human Governance, Societal Governance, Economic Governance and Political Governance. Government provides necessary conditions, framework and environment to corporates to operate. There is, however, no universal recipe for good corporate governance since business environment varies from country to country.

Efforts to articulate standards for corporate governance took roots in countries like the United States and the United Kingdom and have subsequently spread to other countries. The Organisation for Economic Cooperation and Development (OECD) took early initiatives to address governance issues and adopted the OECD Principles on Corporate Governance in May 1999. Equity markets in these countries were not too strong but the investment in equities was on the ascendance. After 1990 the transition from central planning to market driven economies, particularly the privatization of state-owned companies, and the need to provide governance rules for the emerging private sector, brought the issue of corporate governance to the centre stage. As a fall out of 1997 economic and financial crisis, Asian countries too became keenly interested in the issue of corporate governance.

Globalisation of the marketplace has ushered in an era wherein the quality of corporate governance has become a crucial determinant of survival of corporates. The compatibility of corporate governance practices with global standards has also become an important constituent of corporate success. The practice of good corporate governance has, therefore, become a necessary pre-requisite for any corporation to manage effectively in the globalised market.

I Situation of Corporate Governance in India

India is transforming into one of the fastest growing economies, a growing hub of R&D and as an emerging world market. Indian companies today are ranked amongst the best in the developing world. A number of Indian companies are restructuring to become multinational by investing abroad and opening up their branches or subsidiaries. They are competing with MNCs of developed countries in terms of quality and cost. The capital markets are booming not just in terms of stock prices, but in institutional relations as well. Shorter settlement, better margins, and tighter listing and debt norms all have helped in better-governed markets. The Indian rupee has appreciated against the dollar by about 6%, making dollar imports cheaper and fuelling growth. The interest rates are low. Housing and other retail finance has boomed. Exports continue to grow faster than the Gross Domestic Product (GDP), making for a rising share of exports in GDP, a comfortable situation for an economy of India's size. In order to have better financial management of the economics, the government introduced the Fiscal Responsibility and Budget Management Bill[1] in 2000, which was a step in the direction to pave the way for future macroeconomic balance. The year 2002-2003 saw significant developments in infrastructure growth and policy. The central government, though caved in before the business lobby and dropped to introduce value added taxation, but it accepted several of the Kelkar Panel's[2] recommendations to reform tax administration. Faster tax refunds and reduced transaction costs at customs mean thousands of crores of additional funds with the corporate sector.

In order to give a fillip to corporate sector, while aiming at economic liberalization and globalization of the domestic economy, the government initiated the reform process in order to respond suitably to the developments taking place world over. The 1992 stock market scam was another big reason to bring the issue of corporate governance to the centre-stage – to protect the interests of shareholders and to build confidence of foreign financial institutions in the Indian capital market. Numerous committees and various laws were adopted/amended towards good corporate governance in India. The government, however, couldn't push through certain corporate governance measurers included in Companies (Amendment) Bill 2003 based on the Naresh Chandra Committee Report, 2002. The banks have also remained disappointment as they remained structurally unable to lend to any other than the government or the best corporates. The setting up of the asset reconstruction companies under The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002[3] is a good step. Thus, on a whole, a new confidence is discernible in the corporate sector in India.

The Securities and Exchange Board of India (SEBI) reconstituted Justice Bhagwati Committee to take a fresh look and review the takeover regulations and provisions in order to make them more efficient and effective to meet the challenges resulting from economic reforms and liberalization.

1. Economic and Financial Reforms in India

With the increasing integration of world-economy under globalization, India has fundamentally altered its development strategy. Government initiatives since 1991 to restructure the basis of the Indian economy have initiated an economic revolution. New approaches to policy on trade, foreign exchange, anti-trust regulation, banking, industry, foreign investment, and many others are now a familiar part of Indian economy. Dismantling a system of state control, with which India grew since its independence in 1947, was a notoriously difficult task. It was difficult to bring the sustainable policy reforms. The powerful opponents of reforms - farmers fearing the loss of subsidies, protected industrialists fearing foreign competition, political leaders fearing the loss of illicit spoils of office - forged strong opposition, particularly effective were attacks on a reforming government's capitulation to multinational corporations and western dominated multilateral banks, and its betrayal of the socialist commitment to economic justice. Former Indian Prime Minister, Shri Rajiv Gandhi, during 1980s made high-profile efforts to modernize and liberalize the Indian economy, but these efforts were abandoned because powerful interests, both inside and outside the State, forced government to retreat from liberalization. Liberalization eventually returned to India in a lasting form under Prime Minister P.V.Narsimha Rao and Finance Minister Manamohan Singh in 1991. Thereafter, both the coalition governments, the centre-left United Front in 1996 and the Bharatiya Janata Party (BJP) in 1999, that succeeded Congress, continued with reforms. The reforms in corporate sector and securities exchange are thus invariably linked with the political changes that have taken place in India and elsewhere in the world.

From the mid-1960 to the early 1990s, the Indian Government in effect treated the financial system as an instrument of public finance. The government of the day laid down the banks' lending policies and even individual decisions, the banks would receive implicit government (the Reserve Bank of India) guarantees, and the favoured borrowers expanded rapidly. The government's institutions dominated the financial system and the competition was limited. The provision of working capital finance was dependent primarily on commercial and cooperative banks. A few large development banks or financial institutions like the Industrial Development Bank of India (IDBI) and the Industrial Finance Corporation of India (IFCI) provided medium and long-term finance. These institutions were set-up in order to give a primary impulse to economic expansion in important sectors where private enterprise was not forthcoming. For example, they were set-up to finance the requirements of the corporate sector in the fields of shipping, tourism, exports, housing, and development of backward regions and encourage new entrepreneurs. In addition to the traditional methods of raising resources through public and rights issues, resources were raised through 'private placement'. This method of private placement was considered cost and time effective, as it does not require detailed compliance with formalities needed in public or rights issues.

The first attempt at reforming the financial sector was undertaken with the release of the *Chakravarty Committee Report*[4] in 1985. Considering that the reform of the financial sector is an integral part of economic reforms, the government appointed a high - level Narasimham Committee to look into all aspects of the financial system and make comprehensive recommendations for reforms. The Narasimham Committee Report (1991)[5] provided a blueprint for financial reform, particularly in the banking sector and capital market. The government gradually implemented these recommendations, beginning in 1992, and a process of reform in the banking sector and capital market was set in motion. A number of steps were taken to develop transparent and efficient capital and money markets. The most far-reaching reforms have taken place in the area of trade and industrial policy and the system of bureaucratic controls governing international commerce has been dismantled substantially.

The real opening up of the economy started with the issuance of new Industrial Policy on June 24, 1991. The main thrust of the new policy was on relaxations in industrial licensing, foreign investments, transfer of foreign technology and monopolies and restrictive practices laws. Government also announced abolition of industrial licensing for all industries except those specified, irrespective of level of investment. In terms of industrial policy, the central piece of reform was the drastic scaling down of the industrial licensing system and replacing the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP), which had severely restricted the activities of large business houses, with more liberal, the Competition Act, 2002.[6] Industrial delicensing resulted in a spurt of private sector investment and corporate restructuring. This highest level of business activity, in turn, led to further regulatory anomalies that necessitated additional reform in policies relating to taxation, share-markets, foreign joint ventures, and infrastructure. Abolition of licensing freed firms to make independent decisions regarding plant capacity, investment levels and to choose where to locate new ventures. All this forced even the governments of different states in India to compete with one another to create investor-friendly climate. Industries that were previously been the sole preserve of state-owned enterprises have been opened up to the private sector. The sectors that had been highly regulated through licensing were deregulated, while sectors that were once completely off-limits to the private sector moved into the regulated-but-available category.

Liberalization of foreign direct investment and foreign portfolio investment are areas where major reforms have been introduced. Rigorous Foreign Exchange Regulation Act, 1973 (FERA) has been relaxed with liberal Foreign Exchange Management Act, 1999 (FEMA). The government has also taken numerous steps to create the conditions under which deregulated financial markets could operate. For example, it has enhanced the capital base of public-sector banks to meet international norms, interest rates have been given relative freedom to seek their natural market levels, the Reserve Bank of India (RBI) has set-up a dealer network to provide liquidity to government security markets, and the growth of ‘equity-cult’ has begun due to liberalization of the industrial sector and the regulations provided by SEBI to protect investors.[7]

The most important decision, which channelled household savings into shares and debentures, was the abolition of the Controller of Capital Issues (CCI) in 1992. The CCI, with an objective of investor protection, laid stringent controls over public and rights issues and their pricing. The abolition of the CCI left companies free to decide the price of issues. Its successor, the Securities and Exchange Board of India (SEBI), made regulations to govern primary public issues as well as secondary market trading to bring capital markets closer to international norms. In areas, like the information that promoters must provide, the control on insider trading, the effective management of companies, the true and fair accounting standards, new regulations have been designed to increase market liquidity, transparency and enforce effective market system.

It is also significant to note that before 1991, the Indian economy was overwhelmingly *relationship-based system*.[8] After liberalization, the volume of profitable investment opportunities greatly exceeded the available capital. This capital shortage in turn prompted a momentous change in the opening up of the economy to foreign capital flows - a development that coincided with the increased desire of foreign banks, financial institutions and fund managers for international diversification. But the flood of foreign capital poured into at a time when the institutional infrastructure was not adequately developed. As a result, the *market-based*[9] capital was lent into a *relationship – based* system that did not have adequate price signals to deploy the massive inflow of capital properly. Foreign lenders also did not have the institutional safeguards to protect their investments, therefore they kept their loans and investments short-term so that they could pull out at any indication of trouble. It is necessary for any country faced with the prospect of substantial financial inflows, either to accept the risk of financial fragility or to improve its financial infrastructure. In India, therefore, the institutions such as stock exchanges and custodial services were set up; monitors such as credit-rating agencies, auditors, and supervisory authorities were established or strengthened; accounting standards and disclosure laws improved; and bankruptcy and contract law were made more effective.[10] All these reforms clearly demonstrated that Indian political conditions are not inhospitable to the introduction and consolidation of a market-oriented direction for economic policy.

It is also clear that the Indian economy typically combines elements of both the relationship-based and market-based systems. A large network of commercial banks, financial institutions, stock exchanges, and a wide range of financial instruments characterize Indian economy. Following financial sector reforms since 1992, many new private as well as foreign banks, financial institutions, and mutual funds have entered the capital market. The public sector banks have also diversified into several new areas like merchant banking, mutual funds, leasing, venture capital, factoring, and other financial services.

2. Corporate Law and Securities Exchange in India

The Corporate Law

The development of company law in India has so far followed the footsteps of English law with some exceptions. There are nearly 630,000 joint stock companies which, by and large, have played their part in the industrial and economic development of India. But the corporate law in India has witnessed waves of changes along with streamlining of rules, regulations, code of conduct and corporate governance mandate. When the monumental Securities and Exchange Board of India Act, 1992[11] came into existence, quickly a host of ancillary acts, regulations and guidelines appeared at the corporate horizon.

The initial drive for better corporate governance, however, came after the onset of international competition consequent to liberalization of economy that began in 1990.[12] At least five developments are responsible in India for the intense focus on corporate governance issues: (i) Many companies were falling behind in the rate at which they were investing in new plants and equipments, or introducing new products. Indian companies were abandoning markets to foreign competitors rather than committing themselves to stay in and compete harder for market share. (ii) The attempted hostile takeovers and corporate restructuring, the financial market pressures to focus on quarter's earnings, even at the expense of long-run performance and the development of numerous other takeover strategies and defenses raised legal and policy questions about the right of shareholders, the role of directors, and their responsibilities to various corporate constituents. (iii) A huge increase in the compensation packages of corporate executives, even in companies that were slipping badly in their return to investors. (iv) The continuous process of down-sizing virtually in every sector of the economy, and (v) various corporate frauds and securities scams which brought corporate governance issues to the forefront.

Administration of Company Law in India

Entries 43 and 44 of List I of Schedule VII of the Constitution of India, 1950 empower the Parliament to legislate on company affairs. These legislative powers of the Parliament, under the Constitution, clearly define that the act of incorporation which gives birth to the rights and liabilities of a company as a legal entity, are to be regulated by the law under which the company is created.

1. Under the Companies Act, 1956 in the manner provided by the Act (or it might have been incorporated under any of the earlier Companies Act);[13] or

2. By means of a Special Act of Parliament.

Institutions created by the Parliament are better known as corporations, while those incorporated under the Companies Act are known as companies. The incorporated companies doing business for profit are mostly incorporated under the Companies Act. The Companies Act 1956 has recently been amended by the Companies (Amendment) Act, 2000 and Amendment Act, 2002. The Companies (Amendment) Bill, 2003[14] was introduced in Parliament (Rajya Sabha) on May 7, 2003 to further amend the Companies Act, 1956, which has now been withdrawn under the pressure of business sector.

The Department of Company Affairs (DCA) is now contemplating a comprehensive overhaul of the Companies Act, 1956, which comprises about 650 sections, with a fewer sections than in the existing law and laying out the broad policy framework for regulating the operations and management of companies. This simplification process shall remove needless procedural requirements that may have outlived their utility; regroup related provisions that are at present scattered; make it simple and easier to understand. A substantial portion of the existing Act could be enforced through rules notified under the Act rather than through sections of the legislation. The reason is that modifications to the rules can be made by the DCA in consultation with Law Ministry under its delegated powers whenever situation warrants a change; while moving amendments to the main provisions of the Act is a long drawn process and could take several months before Parliament gives it assent. Moreover, the changes to rules can be notified within days.

There is considerable overlap in the powers of the DCA, SEBI and stock exchanges in the administration of company law. The DCA regulates companies as per the Companies Act, while listed companies are also bound by SEBI's guidelines. A simplified Act would only lay down the broad principles while the details of the rules and regulations could be framed by the relevant regulatory organizations. This would also help in clearly establishing responsibilities and liabilities of various organizations concerned with corporate management. There is also a great need for simplification to demarcate the areas amongst the regulators. There are several provisions, which are ambiguous and capable of more than one interpretation. It is also imperative that the Companies Act, in accordance with the findings of the Naresh Chandra Committee [15] and the Joshi Committee,[16] be classified broadly into three parts:

1. Regulation of private companies and unlisted closely held public companies;

2. Regulation of public listed companies, foreign companies, government companies including private companies that are subsidiaries thereof; and

3. Regulations relating to winding up, compromises, arrangements, reconstructions and rehabilitation of the above companies.

This would rationalize and simplify the Act and increase the compliance rate.

Various regulatory provisions of the Companies Act, 1956 and SEBI Act, 1992 are primarily aimed at ensuring that the franchise of incorporation of companies and utilizing public money is not misused for private gain to the detriment of common goods of the shareholders and the community. The legislation in India has created various statutory authorities, tribunals, and courts to regulate the incorporation management and winding up of companies (as they all have to comply with the directions and regulations imposed under the Statute). Thus, the companies administration has necessitated a complex set-up. The DCA was established in August, 1955 and its functions also included certain matters allied to company law, e.g., the stock exchanges and control of capital issues, which were, however, later on taken away. With the Companies (Second Amendment) Act, 2002,[17] the Act recognizes the following administrative authorities, besides the courts of law:

The Central Government (Government of India);
The National Company Law Appellate Tribunal;
The National Company Law Tribunal;
The Regional directors;
The Registrar of companies;
The Official Liquidators;

Indian Capital Market and the Securities Exchange

India has a long tradition of functioning capital markets - the Bombay Stock Exchange (BSE) is over a hundred years old. India's capital market has experienced rapid growth, with its 24 stock exchanges. Until the 1980s, the volume of activity in the capital market was limited. Its activity expanded rapidly during the 1980s as a source of finance for the larger corporations. During this period, capital markets acted as an escape valve for the larger corporations from the repressed banking system. Despite the size, the capital market suffered from numerous problems:

1. They remained primitive and poorly regulated.

2. Under the Capital Issues (Control) Act, 1947, companies wishing to access the capital market needed prior approval from the Controller of Capital Issues (CCI) for raising capital and fixing the premium on the issue price. Equity issuance until 1992 was regulated by the government, with the issue price computed on the basis of an accounting formula rather than what the market might bear. This system forced companies to price new equity issues at levels substantially lower than market prices, ostensibly as a measure to protect small investor. This implicitly penalized firms raising capital from the public, so the volume of equity raised in the capital market was relatively small. This Capital Issues (Control) Act, 1947 Act was repealed in 1992 and statutory control on floatation and pricing of issues was abolished, subject only to certain disclosure requirements.

3. Before 1992, while the new issues were strictly controlled, there was inadequate regulation of stock market activity and also of various market participants including stock exchanges, brokers, and mutual funds, etc.

4. The domestic capital market was also closed to portfolio investment from abroad except through a few closed ended mutual funds floated abroad by the Unit Trust of India (UTI).

5. Information and transparency were limited, reflecting the individual, dealer-based trading system (without market makers), and the associated difficulty in determining the actual price traded, or even highs and lows during the day.

6. The Controller of Capital Issues' regulations on pricing initial public offerings (IPOs) and the time between application and issue kept the IPOs from reflecting the market.

7. Trading in the capital markets was also costly, reflecting the lack of competition due to dominance of Bombay Stock Exchange (BSE).

8. Arbitrage between the exchanges was weak, reflecting both limited information associated with the dealer system and poor telecommunications. If dealers went bankrupt, it prevented completion of transactions and, sometimes a paralysis of payments for the whole market.

9. The retail trading was low. Mutual funds, which could help retail investors improve their access to information and reduce transaction costs, were limited. The government-run UTI had a legal monopoly in the mutual fund market until 1987-88 and faced competition only from public sector banks until 1993-94. Capital markets were thus ineffective in fulfilling their normal function of providing even basic price information, not to speak of accounting standards.

Capital market reforms began in 1992, along the lines recommended by the Narasimham Committee. It aimed at removing direct government control on capital market and replacing it by a regulatory framework based on transparency and disclosure supervised by an independent regulator. The requirement of prior government permission for accessing capital markets and for prior approval of issue pricing was abolished and companies were allowed to access markets and price issues freely, subject only to disclosure norms laid down by the SEBI. These equity market reforms took three approaches:

(i) The SEBI was given regulatory powers including regulation of new issues. One of the principal tasks of SEBI was to improve the functioning of the Indian stock market which was lacking in fairness and integrity, prone to speculative excess and showing scant regard for the interests of small investors.

(ii) The new exchange, the National Stock Exchange (NSE) was created in 1992 and began operation in 1994. Competing with the Bombay Stock Exchange, it introduced a move from 'open outcry' to screen-based trading;

(iii) Development of a share depository - the immobilization of existing securities in a central depository and their eventual 'dematerialization' so that all transfers of shares are made electronically.

(iv) Setting up an efficient clearance and settlement mechanism.

An important constituent of the reforms strategy was the opening up of the economy to foreign investment – both direct and portfolio. In addition, the government allowed Indian companies to raise capital abroad by issue of global depository rights (GDRs) and foreign currency convertible bonds (FCCBs). All these financial sector reforms resulted in opening up several new sources of funds for the corporate sector and contributed to a stock market boom. Increased reliance on market forces for determining the cost and availability of funds enabled the corporate sector to make an optimum combination of domestic and foreign sources of funds. These reforms almost wholly affected the equity market.

Modernization of Securities Exchange

The National Stock Exchange (NSE) was set up as an automated electronic exchange. It enabled brokers all over the country to link up with the NSE computers and trade in a unified exchange with automatic order matching of buy and sell orders with price time priority, thus ensuring maximum transparency for investors. The NSE rapidly attained a much greater volume than the BSE. Competition from the NSE contributed to substantial reduction in transactions costs, and to substantial increase in transparency and liquidity.

The Depositories Act, 1996[18] also eased concerns about counterfeit shares and eventually improved settlement. Before it, the settlement system was antiquated, involving physical delivery of share certificates to the buyer who then had to deliver them to company registrar to record change of ownership after which the certificates had to be returned to the buyer. This process was very time consuming and also created significant risks for investors. The risks included loss of certificates in transition, fear of fake or forged certificates being involved and disputes at the time of registration because signatures of seller on the certificates may not be matching with the signatures in the records of the registry. The first step towards paperless trading was put in place by enacting legislation which allowed dematerialization of share certificates with settlement by electronic transfer of ownership from one account to another within a depository and for it the National Securities Depository Ltd (NSDL) was opened.

Liberalization of the insurance industry also provided more resources for the long-term capital market. Cuts in liquidity requirements on insurance meant additional resources for private investment. Liberalization of entry into insurance, including foreign firms, increased competition and thereby improved services, products, and prices.

India moved towards capital convertibility on the basis of recommendations of Tarapore Committee on Capital Account Convertibility, 1997.[19] The improved financial services in banking, capital markets and insurance have collectively yielded substantial benefits for Indian firms as well as for investors and equipped them to meet the challenges of the on-going globalization of financial services.

The year 2003 saw the market generating a 73% return. An analysis of stock markets across emerging and developed markets reveals that India is the fifth best performer in percentage terms, recording 73% growth for the calendar year 2003. The returns from emerging markets have been in the range of 17 – 140 % in dollar terms, the highest from Brazil being at 140%, Thailand at 130%, Argentina 128% and Turkey112%. The returns from developed markets are in the range of 26 – 70%, the highest being from Austrian market and the lowest from the Dow Jones Industrial Average at 26%.[20]

This high return resulted largely on account of the unprecedented foreign institutional investment (FII) inflows of US$ 7.59 billion. The capital market is witnessing an extremely high volatility as the foreign institutional investors were buyers in equity and debt market. The net inflows of FII in the Indian equity and debt markets recorded an almost tenfold rise in 2003 at Rs 35,153.8 crore (US $7.59 billion) as against Rs 3,677.7 crore ($763.5 million) registered in the previous year. The number of registered FIIs also grew from 489 to 517 as on December 31, 2003. On a cumulative basis, the grand total of net inflows grew to Rs 94,103 crore ($22.89 billion) from Rs 58,949.3 crore ($15.3 billion) a year ago.

The year also saw the BSE Sensex at around 6000 levels for the first time, since March 9, 2000. The market has doubled in the year 2002-03. With the care taken by SEBI and the companies, there has been a continuous rise in share prices and equity capital is available with new issues and the return of the retail investors. Indian corporates have started to reduce reliance on external sources and are now emphasizing on their own funds for making capital investments.

Measures to Restore Investors Confidence

Although much progress has been made in modernizing the security exchanges, substantial problems, nevertheless remain. An important issue is to restore confidence among small investors. One reason for the reluctance of small investors to enter the market is the low level of confidence about corporate governance in many listed companies. Information disclosures by the listed companies are still poor by international standards, and are not conducive to the creation of market efficiency. Corporate governance standards are weak, and neither regulation nor large institutional shareholders have succeeded in rapidly strengthening them. A pre-condition for healthy capital market is the existence of institutions, which ensure high levels of corporate governance. These include high standards of accountancy to ensure transparency in financial performance, active involvement of institutional investors in monitoring performance based on good quality equity research inputs and also codes of corporate governance which are designed to ensure that managements are subjected to effective oversight by boards and that shareholders interests are protected. India's capital market is as yet far from this ideal though some corrective processes are at work. There is a need to upgrade information through better auditing and accounting.

SEBI keeps a close watch on the functioning of the exchanges, the conduct of the intermediaries and the corporates. SEBI has added a lot of staff in the surveillance department and its two divisional chiefs are exclusively responsible for surveillance work. They analyze every unusual movement in the market on daily basis.

3. Statistics

Number of Corporate Entities

There are over 9,000 companies quoted on the stock market out of a total population of around 630,000 companies.

In the beginning of 19th century, the numbers of joint stock companies with limited liability were 1,340 with a total paid-up capital of Rs 35 crores. During the next ten years ending 1909-10, the number increased to 2,216 and paid-up capital to Rs 61 crores. In 1920,the number of companies was 3,368 and their paid-up capital Rs 230 crores. Joint stock companies received a fillip during the First World War and the *swadeshi* (national) movement.

At the beginning of the Second World War in 1939, the number of companies was 11,114 and the total paid-up capital Rs 290 crores. The war and post war periods witnessed a boom in the floatation of companies.

In 1950, the number of companies increased to 27,568 with paid-up capital of Rs 724 crores. In the year 1959-60 there were 26,897 companies with a paid-up capital of 1,024 crores at work. The number of companies went down because of the administrative drive launched by the Department of Company Law Administration to weed out the moribund (inactive) companies.

The current position is that up to October, 2003, there were 6,31,873 companies at work and out of which 76,889 are Public companies limited by shares, 5,51,317 are Private companies limited by shares, 3174 are Guarantee companies and there are 493 Unlimited liability companies.

Out of this grand total, there are 1,305 Government companies, of which 692 are Public Limited Companies, 607 Government private limited companies and 6 Government guarantee companies.

Number of Companies at work during January 2002 – October 2003

Period	Public	Private	Govt	Total	Total Number
2002					
Jan	108	1811	1	1930	5,89,455
Feb	98	1609	1	1708	5,91,036
March	80	1570	1	1651	5,92,728
April	99	1893	4	1996	5,94,578
May	101	1993	5	2099	5,96,591
June	81	1849	2	1932	6,00,055
July	85	1671	0	1756	5,98,196
August	83	1788	2	1873	6,01803
September	86	1961	1	2048	6,03,778
October	77	1735	0	1812	6,05,471
November	85	1664	1	1750	6,07,194
December	100	2067	3	2170	6,05,768

Period	Public	Private	Govt	Total	Total Number
2003					
January	97	2259	1	2357	6,11,539
February	103	2093	1	2197	6,13,667
March	112	2001	2	2115	6,15,755
April	99	2123	0	2222	6,17,872
May	102	2268	4	2374	6,20,127
June	103	2276	3	2382	6,22,383
July	123	2360	0	2483	6,24,773
August	96	2160	1	2257	6,26,974
September	89	2472	2	2563	6,29,480
October	90	2313	6	2409	6,31,873

Source: Figures compiled from various reports of the DCA, Government of India website: http://www.dca.nic.in

Number of Companies for Bankruptcy

During the year 2002, eight hundred forty five companies ceased functioning either by going into liquidation or their names having been struck off under section 560 of the Companies Act[21] and up to October, 2003, six hundred seventy four companies ceased to work either by going into liquidation or their names being struck off.

A High Powered Central Coordination and Monitoring Committee (CCMC) co-chaired by Secretary, Department of Company Affairs (DCA) and Chairman, SEBI, set-up seven Task Forces for taking prosecution proceedings against vanishing companies. The Regional Directors and Registrar of companies of the respective regions are the conveners, and regional offices of SEBI and stock exchange are as members of these forces. In the year 2003, prosecution against 149 companies was initiated under sections 63, 68 and 628 of the Companies Act, 1956.[22]

4. Overview of Corporate Governance and Law Reforms in India

Corporate governance has been a buzzword in India since 1998. But the need to have a good mechanism started since the beginning of 1990s when the Indian stock market rocked with many scams. On account of the interest generated by Cadbury Committee Report (1992) in UK, the Confederation of Indian Industries (CII), the Associated

Chambers of Commerce and Industry (ASSOCHAM) and the Securities and Exchange Board of India (SEBI) constituted Committees to recommend initiatives in Corporate Governance. The recommendations of the Kumar Mangalam Birla Committee, constituted by SEBI, led to the addition of Clause 49 in the Listing Agreement. These recommendations, aimed at improving the standards of Corporate Governance, are divided into mandatory and non-mandatory recommendations. The recommendations have been made applicable to all listed companies, their directors, management, employees and professionals associated with such companies. The ultimate responsibility for putting the recommendations into practice lies directly with the Board of Directors and the management of the company. The latest developments include constitution of a high-powered Committee by Department of Company Affairs, Government of India, headed by Shri Naresh Chandra, on August 21, 2002, to examine various corporate governance issues.

Other developments include the constitution of a Committee by SEBI under the Chairmanship of Shri N.R.Narayana Murthy, for reviewing implementation of the corporate governance code by listed companies and issue of revised clause 49 based on its recommendations; setting up of a proactive Standing Company Law Advisory Committee by Department of Company Affairs to advise on several issues like inspection of corporates for wrong doings, role of independent auditors and directors and their liability and suggesting steps to enhance imposition of penalties. Another Committee has been constituted by the Department of Company Affairs known as the Working Group for examination of suggestions received on good corporate governance. A High Powered Central Coordination and Monitoring Committee (CCMC), co-chaired by Secretary, Department of Company Affairs and Chairman, SEBI was set up to monitor the action taken against the vanishing companies, and unscrupulous promoters who misused the funds raised from the public. It was decided by this Committee that Seven Task Forces be set up at Mumbai, Delhi, Chennai, Kolkata, Ahmedabad, Bangalore and Hyderabad with Regional Directors/ Registrar of Companies of respective regions as convenor, and Regional Offices of SEBI and Stock Exchanges as Members. The main task of these Task Forces was to identify the companies, which have disappeared, or which have misutilised the funds mobilized from the investors, and suggests appropriate action in terms of Companies Act or SEBI Act. SEBI says that the Corporate governance norms introduced for listed companies vide clause 49 of the listing agreement on the basis of the Kumaramanagalam Birla Committee Report, 1999 have met with encouraging success, since most of the ‘A’ Group companies listed on BSE and NSE have complied with the norms. However, the corporate governance has remained more on paper is clear from the Report on Corporate Governance by the Advisory Group constituted by the *Standing Committee on International Financial Standards and Codes of the Reserve Bank of India*.[23]

The following facts emerged from the report:

(i) The predominant form of corporate governance in India is ‘insider model’ where promoters dominate governance in every possible way. Indian corporates which reflect the pure ‘outsider model’ are relatively small in number.

(ii) A distinguishing feature of the Indian Diaspora is the implicit acceptance that corporate entities belong to founding families.

(iii) The listing agreement, the main instrument, through which SEBI ensures implementation of corporate governance, is a weak instrument, as its penal provisions are not stringent. The maximum penalty a stock exchange can impose on any company that does not follow the corporate governance norms is suspension of trading in its shares. This penalty hurts the investor community more than the management of the company that violates the listing agreement.

(iv) Regional stock exchanges where a large number of companies are listed lack effective organization and skills to monitor effective compliance with corporate governance norms.

(v) A vast majority of companies that are not listed remain outside the purview of SEBI’s measures.

(vi) The financial institutions that have large shareholdings in most of the listed companies have been passive observers in the area of corporate governance and do not effectively exercise their rights as shareholders.

(vii) The autonomy of the Boards of Public Sector Units and public sector banks has been seriously eroded due to special legislative provisions or notifications and day to day interference by the concerned administrative ministries.

It is interesting to note that despite corporate governance in the form of clause 49 was already introduced in the year 2000, it could not prevent securities scam of 2002. Events in the stock exchanges have exposed the lack of ethical conduct by many Indian corporates:

(i) Rampant insider trading by the promoters in league with big market players.

(ii) Massive price rigging/ manipulation by the promoters in league with big market players prior to mergers and takeovers.

(iii) Gross misuse of bank funds for clandestine stock market operations.

(iv) Criminally motivated investment in violation of laid down norms.

(v) Many companies, which raised money from the capital market through public issues, have not paid any dividend for more than five years.

(vi) The total amount of money (collected through public offerings) duped by the vanishing companies is calculated to be Rs 66,861 billion;

(vii) Non-performing assets of scheduled commercial banks amounted to Rs 58,554 billion as on 31 March 2003.

In addition small investors have lost their hard earned money in the stock markets for the following reasons:

(i) Lack of ethics, selfish conscience, and breach of trust on the part of the promoters.

(ii) Lack of adequate compliance mechanism, supervision, proper inspection, effective regulation and preventive action by regulators like Department of

Company Affairs, Registrar of Companies, Board of Stock Exchanges as well as SEBI.

(iii) Lack of professional ethics on the part of professionals, like Chartered Accountants, Company Secretaries etc, who are holding onerous positions in companies.

It all establish that no matter that most of the companies may be fully complying with the corporate governance norms laid down by clause 49, but absence of good conscience on the part of the promoters to observe ethical practices have created little impact in practice.

A number of proposals have been made to improve corporate governance. The various suggested reforms include: (i) strengthening the position of internal and outside auditors; (ii) allowing mergers and acquisitions approved by a panel; (iii) requiring more independent outside directors on boards; (iv) introducing the supervisory board or two-tier system; (v) allowing banks to own greater equity in shares of the companies; (vi)enhanced disclosure through consolidated balance sheets and enforcement of accounting standards.

An important mechanism required to make the capital marked discipline is liberalization of restrictions on mergers and acquisitions. Secondly, the bankruptcy provisions be allowed to operate without any government interference. Another important commitment necessary on the part of government, is that it should discontinue directed lending and permit commercial banks and government financial institutions to be run by their boards in the interest of their shareholders rather than the government.

In India, the four clusters of legal arrangements have been developed to respond to corporate governance problems. These are securities market regulations, the fiduciary responsibilities of directors and officers, laws governing takeovers, and rules governing shareholder voice. The two most important laws that control the listed companies are the Securities Contracts (Regulation) Act, 1956 which regulate all new public offerings, dealings in stock market and the functioning of the stock exchanges in India and the Securities and Exchange Board of India Act, 1992 which created the Securities and Exchange Board of India (SEBI), giving it the authority to administer the Securities Contracts (Regulation) Act, and all the other regulation of securities. The major purpose of these laws is to require regular, accurate, and timely public disclosure of financial information by any company that issued publicly traded securities and to instill public confidence in the reliability and accuracy of information so reported. A new law called the Indian Competition Act, 2002 has been enacted to replace the MRTP Act, 1969. The objective of the new law is to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interest of consumers and to ensure freedom of trade carried on by other participants in markets and for matters connected therewith or incidental thereto.

The Companies Act, 1956 and the Listing Agreement

The opening of the Indian economy and the necessity to have good corporate governance, made the government of India to take number of steps through suitable provisions in the Companies Act, 1956 and through the Listing Agreement. If a company intends to offer its shares or debentures to the public for subscription by the issue of a prospectus, it must, before issuing such prospectus, apply to recognized stock exchange for permission to have the shares or debentures intended to be so offered to the public to be dealt with in stock exchange in terms of section 73 of the Companies Act, 1956. Section 73 of the Companies Act makes listing compulsory where a company makes a public issue of shares or debentures by prospectus. It may be noted that Securities Contract (Regulation) Act, 1956 does not make listing of securities compulsory.

The listing agreement is required to be complied by only listed companies with stock exchanges in which the concerned company's shares are listed. While the requirements in relation to corporate governance set out in the Companies Act apply to all companies and the Department of Company Affairs administrates the Companies Act; the listing agreement apply to listed companies and is administered by stock exchanges under the supervision of SEBI, i.e., under the Securities Contracts (Regulation) Act, 1956 and the SEBI Act, 1992.

The requirements in the listing agreement are inserted through the directives issued by the SEBI to which the Ministry of Finance has delegated powers. The number of requirements under the Companies Act and in the listing agreement is uniform, but on some major aspects, including the composition of the board, they vary. This obviously creates practical problems for listed companies.

SEBI has put a modern regulatory framework with rules and regulations governing the behaviour of major market participants such as stock exchanges, brokers, merchant bankers, and mutual funds. It also regulates activities such as takeovers and insider trading which have implications for investor protection. SEBI has liberalized the regulation of new issues, including allowing book building. It has also increased information requirements for listed shares. The governing structure of stock exchanges has also been modified to make the boards of exchanges more broad based and less dominated by brokers.

5. Guidelines and Codes of Corporate Governance

In 1995, the Confederation of Indian Industry (CII) took a special initiative on corporate governance – the first institutional initiative by Indian industry. It was soon followed by the professional bodies like the Institute of Companies Secretaries of India (ICSI) during the year 1996-97 to focus the attention of the Indian corporate sector on the imperative need to evolve new norms of governance to sustain and develop Indian industry on healthy lines. A working group, set up by the Department of Company Affairs, also looked into the matter of Corporate Governance, which needs to be introduced. The pressure for change was because of lack of confidence of individual investors as well as of institutional investors. In 2002, the Security and Exchange Board of India, as well as the Department of Company Affairs established Narayana Murthy Committee and Naresh Chandra Committee, which in their reports have provided guidelines for corporate governance, keeping in view developments in corporate sector especially in the USA.

CII Code of Corporate Governance[24]

In December 1995, the CII set-up a Committee under the chairmanship of industrialist Rahul Bajaj to prepare a comprehensive voluntary code of corporate governance for listed companies. The final draft report was released in April 1998. The CII Code on corporate governance recommended that the: key information to be reported, listed companies to have audit committees, corporates to give a statement on value addition, consolidation of accounts to be optional. Main emphasis was on transparency, as stated by Shekar Datta, the then President of CII, in the foreword to the Report:

"Corporate Governance is a phrase which implies transparency of management systems in business and industry, be it private or public sector –all of which are corporate entities. Just as industry seeks transparency in Government policies and procedures, so, corporate governance seeks transparency in corporate sector.

UTI Code of Corporate Governance[25]

In the year 1999, the Unit Trust of India (UTI) also formulated a code of corporate governance. This was followed by the professional bodies like the *Institute of Company Secretaries of India (*ICSI) to focus the attention of the Indian corporate sector, on the norms of governance and it set up a National award on Excellence in Corporate Governance.

Birla Committee Report on Corporate Governance

SEBI constituted a Committee on corporate governance with as many as 18 members under the chairmanship of Shri Kumar Managalam Birla, to promote and raise the standards of corporate governance in respect of listed companies on 7th May 1999. This Committee, after a good deal of deliberations with industrial associations and professional bodies, submitted its report on 25th January 2000,and recommended various new norms of corporate governance. SEBI accepted the recommendations, which culminated in the introduction of clause 49 in the standard Listing Agreement for implementation by all stock exchanges for all listed companies, within a time frame of three years commencing from the financial year 2000-2001. The main recommendations of this Committee related to the composition of the board including independent directors, constitution of audit committee in certain sized companies to look into the financial aspects of a company, remuneration of directors, director's report to include management discussion and analysis report, better disclosure norms to the shareholders through annual report, etc.

Regarding the composition of the board of directors of a company, the Committee was of the view that the composition of the board of directors is critical to the independent functioning of the board as it determines the ability of the board to collectively provide the leadership and ensures that no one individual or group is able to dominate the board. The committee recommended that the board of a company should have an optimum combination of executive and non-executive directors, with not less than fifty percent of the board comprising the non-executive directors. As the executive directors are involved in the day-to-day management of companies, the non-executive directors bring external and wider perspective and independence to the decision-making.

It has been the practice of most of the companies in India to fill the board with representatives of the promoters of the company as independent directors. This has undergone a change and now the boards comprise of following groups of directors:

Promoters' directors, Executive directors, non-executive directors, a part of whom are independent.

Based on these recommendations, the Companies (Amendment) Act 2000 introduced many provisions relating to corporate governance including (a) additional ground of disqualification of directors in certain cases, (b) setting up of audit committees, (c) director's responsibility statement in the directors' report, (d) introduction of postal ballot for transacting certain items of business in the general meeting, and (e) enforcement of accounting standards.

Corporate governance was also introspected by the Advisory Group constituted by the Standing Committee on International Finance Standards and Codes of the Reserve Bank of India under the Chairmanship of Dr. Y.V.Reddy the then Deputy Governor and later on the Governor of RBI.[26] All these efforts focused the attention of the corporate boards that they should manage the affairs of companies with better accountability to shareholders and achieve transparency of operations with disclosure of both financial and non-financial data through annual report and other periodical reports. As a result, annual report of listed Indian companies, now reflect in adequate measure the new norms of governance.

Naresh Chandra Committee Report on Corporate Audit and Governance (2002) [27]

The Enron debacle in July 2002, involving the hand-in-glove relationship between the auditor and the corporate client and various other scams in the United States, and the consequent enactment of the stringent Sarbanes – Oxley Act in the United States were some important factors, which led the Indian government to wake up. The Department of Company Affairs in the Ministry of Finance on 21 August 2002, appointed a high level committee, popularly known as the Naresh Chandra Committee, to examine various corporate governance issues and to recommend changes in the diverse areas involving the auditor-client relationships and the role of independent directors. The Committee submitted its Report on 23 December 2002.

In its report, the Committee commented on: (a) the poor structure and composition of the board of directors of Indian companies, (b) scant fiduciary responsibility, (c) poor disclosures and transparency, (d) inadequate accounting and auditing standards, (e) the need for experts to go through the minutest details of transactions among companies, banks and financial institutions, capital markets etc. On the auditor – company relationship, the Committee recommended that the proprietary of auditors rendering non-audit services is a complex area, which needs to be carefully dealt with. The recommendations of this Committee are more or less in line with the Rules framed by the Securities & Exchange Commission (SEC) in accordance with the provisions of the Sarbanes-Oxley Act 2002. The recommendations of the Naresh Chandra Committee are expected to play a vital role in strengthening the composition and effectiveness of the regulatory framework for good corporate governance.

Narayana Murthy Committee Report on corporate governance

In the year 2002 SEBI analyzed the statistics of compliance with clause 49 by listed companies and felt that there was a need to look beyond the mere systems and procedures, if corporate governance was to be made effective in protecting the interests of the investors. SEBI, therefore, constituted a committee under the Chairmanship of N.R. Narayana Murthy, Chairman of Infosys Technologies Ltd to review the performance of corporate governance in India and make appropriate recommendations. The Committee included representatives from the stock exchanges, chambers of commerce and industry, investor associations and professional bodies. The Narayana Murthy Committee submitted its report on 8 February 2003.

In the meantime many of the recommendations of the Naresh Chandra Committee found their acceptance in the form of the *Companies (Amendment) Bill of 2003*, which was introduced in the Parliament in May 2003, but now had been withdrawn. The mandatory recommendations of the Committee relate to; (a) the role and functions of the Audit committee, (b) the risk management and minimization procedures, (c) the uses and the application of funds received from the initial public offers, (d) code of conduct for the board, (e) nominee directors and independent directors.

Concept of Corporate Excellence

Corporate excellence is a way ahead of corporate governance. The Department of Company Affairs (DCA) in 2000 appointed a study group under the chairmanship of Dr. P.L. Sanjeeva Reddy, Secretary DCA to suggest ways and means of achieving corporate excellence and to explore the possibility of putting in place an implementable system and develop firm infrastructure. The study group constituted a Task Force under the Chairmanship of S. Rajagopalan, former Chairman, Mahanagar Telephone Nigam Limited (MTNL). This task force inter-acted with the delegates of Commonwealth

Secretariat on Centre for Corporate Governance, various chambers of commerce and professional bodies.

The key recommendations of the study group were:

(i) Setting up an independent autonomous centre for corporate excellence, with a view to accord accreditation to promote policy research and studies, training and education awards etc. in the field of corporate excellence through improved corporate governance.

(ii) Introducing measures for greater shareholders' participation, through multiple location meetings, and electronic media etc.

(iii) Introducing recognition of corporate social responsibility with Triple-bottom Line Accounting and Reporting.

(vi) Clearer distinction between direction and management to ensure that executive directors are held responsible for legal and other compliance with non-executive directors being charged with strategic and overall responsibilities.

(v) Highlighting directors' commitment and accountability through fewer and more focused board and committee membership, tighter independence criteria and minimization of interest-conflict potential.

(vi) Suggesting application of corporate governance principles to public sector undertakings both in the listed and unlisted companies and upgrading their board with independent directors.

6. Structure of Corporate Ownership

Family and Business Groups Ownership: For the purpose of ownership, Indian companies can be classified into four categories: publicly held companies, privately held companies, family controlled companies, and the state owned (Government) companies. The structure of the ownership, even in the publicly held companies is unusual. Most of these companies, even the listed ones, have a dominant owner who is very often involved in the management of the company. Business groups are notable feature of the Indian corporate sector. They are organized through extensive cross-ownership and are often dominated by a controlling family, who has good contacts in the government. Thus, Indian companies are still controlled by the founder promoter and his family members who on an average own a minority of shares, often as few as 10 percent, and through cross-holding control another 30% to 40%, of the group member firms. These controlling groups are known as promoters, as in the distant past, they did promote the companies. In listed companies, a large block of equity of about 30 - 50% is held by public financial institutions (both foreign and domestic), which seldom sell their shares and rarely challenge the promoters.

This type of ownership structure has its roots in the pre-independence managing agency system that was abolished on 1 April, 1970. But there are few signs of a well-functioning corporate control in this structure. One reason for this is that a typical public corporation is closely held and in most of the cases is dominated by the founder and his family or his associates. Secondly, the external equity is relatively small part of capital structure. The bulk of finance is supplied by bank debt and retained earnings. Bank debt is often provided on a subsidized basis from government-controlled banks. Given these financing sources, along with the limited legal rights of minority shareholders, public companies face little pressure for change until the "crisis" hits the company. The government has also pursued a number of policies with the aim of achieving wider shareholding and discouragement of any active market in shares. The takeover code also provides that 'no one' may raise shareholding above 10 percent without making a prior public announcement of intention and a public offer to purchase 20% holding at the average market price of the previous six months, and thus acquire at least a 30 percent holding. Listing on the first-tier of the stock exchange now requires that over 40% of the company's stock be held by shareholders owning less than 1%, and that the principal owner and his family own not more than 51%. Cross-shareholdings by a firm may not exceed 25% of its net equity capital. A bank cannot without the permission of the RBI own more than 10% of a company's shares.

Institutional Shareholders: Financial Institutions own more corporate equity than individual shareholders. Mutual funds have become more acceptable investment vehicle. Financial assets held by financial institutions exploded after 1991. The holding of the Financial Institutions is concentrated in the larger companies. While any one institution typically owned a relatively small portion of a corporation's equity, some institutions hold substantial, if taken as a group. These institutional owners are professional owners. They exercise almost all the rights and privileges of equity ownership. They buy and sell, they vote proxies, make proxy proposals, monitor portfolios firms, and communicate their concerns to management.

The fiduciary duty empowers and legally requires Financial Institutions to act conservatively and vigorously to promote their beneficiaries' interests. This has led institutional investors to promote corporate governance reforms that strengthen their ability to act as owners, to vigorously monitor under-performing portfolio companies, and to oppose management when they determine that it is not acting in the best interests of the shareholders.

Foreign Institutional Investors: An Economic Times analysis[28] of FII holding in BSE 200 scrips as on December 31, 2003 indicates that foreign institutional investors control 13.3% of the total market capitalization. The total market capitalization of the BSE 200 scrips is Rs 10,19,6630 million out of which the market capitalization of FII holdings is Rs.1, 35,5410 million. According to latest Morgan Stanley research, only foreign institutional investors (FII) now on an average own 30% stake in the top ten Indian corporations and their stake in the top 50 companies is, on an average, more than 17.5%. The FIIs in India own more than a third of the non-promoter group holding.

Government Ownership: Government is a major shareholder in the corporate sector. The Government has holdings in private sector either through the public financial institutions or a government company's subsidiary.

7. Shareholder v. Stakeholder:

To maximize the value of shareholders' investment is considered as primary corporate objective. This objective is reflected in different corporate governance reports made in India, which emphasize the duty of board to represent stakeholders' interest and maximize shareholder value. It has been observed that board's main aim is to protect and enhance the shareholders investment in the company, though some emphasis is placed on a broader range of stakeholders such as employees, creditors and other constituents. But this view is not strongly advocated in the governance guidelines and codes or listing agreement. However, there is growing recognition to address stakeholder interests in order to maximize shareholder value over the long run.

The Naresh Chandra Committee recognizes that 'the board responsibilities to shareholders as well as to customers, employees, suppliers and the communities in which the company operates are all founded upon the successful perpetuation of the business.' Thus, it is presumed that shareholders and stakeholders interests are compatible in the success of the company in the long run.

II Legal and Institutional Reforms for corporate Governance Improvement

1. Legal development regarding Corporate Governance in India

In India, the family owned business houses followed their particular way of governance, which suited them. The stakeholders considered them as acronyms of competence and trust. The meager holding of the families in their company's capital, non-transparency at various levels on various matters and superficial professionalism on the board with no public disclosure did not bring any reaction from the stakeholders, in a protected economy, till the seventies in India. Non-separation of ownership from the management generated corruption in business and resulted in denial of the value to the stakeholders.

In India, the fundamental concern of corporate governance is to ensure the means by which a company's managers are held accountable to capital providers for the use of assets. The past five years has witnessed a proliferation of corporate governance guidelines, reports and codes designed to improve the ability of corporate directors to hold management accountable. Although, the board of directors provide an important mechanism for holding management accountable, effective corporate governance is supported by and is dependent on market for corporate control, securities regulation, company law, accounting and auditing standards, bankruptcy laws, stock exchange listing rules and judicial enforcements.

In order to improve the corporate performance, a number of government and industry initiatives have been taken to lay down the necessary laws, bodies and guidelines for corporate governance. The most notable are the voluntary Code of Corporate Governance