Corporate Governance in India: Past, Present and Future?

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Over the last few months we have witnessed the revelation of some of the largest corporate frauds in history.[1] India, too, has not been spared from the spate of corporate wrongdoing with the recent discovery of massive fraud at Satyam.[2] However, one of the most puzzling aspects of these events is that they occurred *after* a series of detailed corporate governance reforms in many parts of the world, including India. This raises important and pressing questions about the regulation of business and, particularly in India, corporate governance. This paper examines the development of corporate governance reforms in India, their effects, and what reforms may be in the offing following the Satyam scandal.

When discussing the development of corporate governance in India, it is important to examine what we mean by corporate governance and why it is considered important. Defining corporate governance is difficult because it affects, and can be affected by, so many different parts of a firm's operations. But as a working definition for the purposes of this paper, I define corporate governance as the rules, norms, and practices that address the relationship between managers and shareholders and amongst different types of shareholders (e.g., controlling shareholders and those shareholders who do

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1 *See* Michael Lewis & David Einhorn, *The End of the Financial World as We Know It*, N.Y. TIMES, Jan. 3, 2009, at WK9, *available at* http://www.nytimes.com/2009/01/04/opinion/04lewiseinhorn.html?_r=1; Michael Lewis & David Einhorn, *How to Repair a Broken Financial World*, N. Y. TIMES, Jan. 3, 2009, at WK10, *available at*: http://www.nytimes.com/2009/01/04/opinion/04lewiseinhornb.html?th; Gardiner Harris, *Peanut Products Sent Out Before Tests*, N. Y. TIMES, Feb. 11, 2009, at A24, *available at* http://www.nytimes.com/2009/02/12/health/policy/12peanut.html?_r=1; Nick Mathiason, *Tax Scandal Leaves Swiss Giant Reeling*, OBSERVER, June 29, 2008, at business pages 4, *available at* http://www.guardian.co.uk/business/2008/jun/29/ubs.banking; Liz Moyer, *Inside The Madoff Mysteries*, FORBES.COM, Dec. 16, 2008, http://www.forbes.com/2008/12/16/madoff-fraud-sec-biz-wall-cx_lm_1216madofffaq.html.

2 *See* Manjeet Kripalani, *India's Madoff? Satyam Scandal Rocks Outsourcing Industry*, BUS. WK. ONLINE, Jan. 7, 2009, http://www.businessweek.com/globalbiz/content/jan2009/gb2009017_807784.htm; Joe Leahy, *Calamitous Confessions*, FIN. TIMES, Jan. 13, 2009, at 7, *available at* http://www.ft.com/cms/s/0/fbbcf6a4-e1a4-11dd-afa0-0000779fd2ac,dwp_uuid=a6dfcf08-9c79-11da-8762-0000779e2340.html.

not have control). Examples include rules on related party transactions, disclosure to shareholders, independent boards, proxy voting, and many other matters. In essence, corporate governance is a form of investor protection (as are securities laws and potentially other areas of law as well).[3]

Conceptualizing corporate governance as a form of investor protection helps us address the second question posed above — why is corporate governance important? Of course, one could posit many responses ranging from business ethics to high finance, but I will focus on the one that seems to have received the greatest attention from scholars and practitioners. Corporate governance provides investors with some measure of assurance that the money they have invested in the corporation will not easily be expropriated or grossly mismanaged. Absent these kinds of assurances, investors, especially small passive ones, are likely to be reluctant to invest their money with an enterprise and have little control over how that money is used. If investors are unwilling to provide capital to corporations then that could severely constrain the growth of these corporations, limit their ability to take advantage of business opportunities, and have a hobbling effect on economic growth. In light of this, the potential importance of corporate governance is that strong governance provides greater assurances to investors who then are more willing to invest in firms and help fuel economic growth.

This raises a number of questions I will address in this paper. First, Part I discusses India's corporate governance situation prior to the 1991 economic liberalization reforms. Part II examines the corporate governance reforms enacted toward the end of the millennium while Part III explores recent research on the effects of these reforms. Part IV considers the Satyam fraud and what implications it has for the state of corporate governance in India and what it might suggest for future reforms. Part V concludes.

Before beginning a word of caution is in order. There is a tendency sometimes to think that the only kind of investor protection that matters is the one found in law codes and enforced in courts and regulatory bodies. Although important, legal rules are by no means the only tools by which investors can protect their investments. Studies in both India and elsewhere have shown that other kinds of measures can be taken by investors to protect themselves and that not all

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[3] This approach is consistent with a very influential line of scholarship associated with Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998). One could also include creditor protections laws or rules governing creditor-debtor relationships as a form of protection for another type of capital provider.

corporate laws are value enhancing.[4] I do not discuss the extra-legal methods of ensuring investor protection for the sake of brevity, but it is important to note that business and social norms and other methods can help constrain misbehavior in addition to the laws that may be enacted by Parliament.

I. Corporate Governance Past

India has witnessed increasing and impressive growth rates over the last two decades. However, unlike many other large emerging economies (e.g., China, Brazil, and Russia),[5] India's stock markets experienced substantial and consistent growth prior to the global financial meltdown of 2008. Indeed, India has thousands of firms listed on over twenty domestic stock markets as well as an active private (i.e., not publicly traded) corporation sector. What might explain India's stock market growth when other large emerging markets have yet to taste this level of stock market success?

Some may attribute this, in part, to India's corporate governance system. To fully appreciate the changes wrought by India's governance reforms it is essential to understand the development of corporate governance in India. As we shall see the saga of modern corporate governance in India is, in many respects, the story of the prodigal son — a promising start followed by a decline with much more recent attempts at redemption.

A. Origins of Modern Corporate Governance in India (1866 to 1947)

Although India has had business organizations for many years,[6] I begin our discussion of modern corporate governance during the British Raj and in the mid 1800s. From 1866 onwards many statutes

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[4] *See* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, 149 U. Pa. L. Rev. 1619 (2001); Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 Harv. L. Rev. 460 (2006); Franklin Allen, Rajesh Chakrabarti, Sankar De, Jun Qian & Meijun Qian, Financing Firms in India (April 2009), *available at* http://ssrn.com/abstract=898066.

[5] *See* Yasheng Huang & Tarun Khanna, *Can India Overtake China?*, Foreign Pol'y, July-Aug. 2003, *available at* http://www.foreignpolicy.com/story/cms.php?story_id=95&page=3; Mark Cobley, *Brazil Addresses Investors' Concerns*, Fin. News, July 7, 2008, *available at* Factiva, Document LONFIN0020080709e47a0000u; Mark Cobley, *China Carries the Torch for Shareholders' Rights*, Fin. News, July 28, 2008, *available at* Factiva, Document LONFIN0020080727e47s00004; Mark Cobley, *Russia Stages Velvet Deprivatisation*, Fin. News, July 14, 2008, *available at* Factiva, Document LONFIN0020080714e47e0000t; Johanna Symmons, *Foreign Funds Cautious Over Indian Volatility*, Fin. News, July 21, 2008, *available at* Factiva, Document LONFIN0020080721e4710001d.

[6] Evidence for business organizations in India may date to about 800 B.C.E. *See* Vikramaditya Khanna, *A New View of the Economic History of Business Organizations:*

were enacted addressing corporate governance, trust activity, banking activity, and securities regulation.[7] Further, India has had functioning stock markets since 1875 and some active commodities markets (e.g., cotton). By World War II Indian Industry had grown substantially due in part to the weakening of the Chinese and Japanese economies, which were in some sense competitors, from the damage caused by the War and by wartime activities on their territories.[8] Thus, by the time of Independence in 1947, India appeared to have well functioning stock markets, an active manufacturing sector, a large corpus of corporate and securities laws, and a well-developed banking establishment.[9] Although there were certainly corporate governance abuses, the general state of corporate governance and the overall economy in India placed it in an enviable position amongst many post-colonial countries.[10] This position was, however, about to receive some serious setbacks.

B. Independence to Liberalization (1947 to 1991)

Following Independence the Indian government put in place a number of policies that had the effect, albeit probably unintended, of weakening corporate governance in India. This started with a series of industrial policy resolutions that entrusted the state with much greater responsibility for managing the economy.[11] These policies

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Evidence from Ancient India, (Univ. of Mich. Law Sch. John M. Olin Ctr. for Law & Econ. Discussion Paper No. 2005-014, 2009).

[7] See the Indian Companies Act, 1866; Indian Companies Act, 1882; Indian Trusts Act, 1882; Indian Companies Act, 1913; Reserve Bank of India Act, 1934; 1956 Indian Companies Act (in the process of being re-written); 1956 Securities Contracts (Regulation) Act (defines powers and conduct for stock exchanges); 1985 Sick Industrial Companies (Special Provisions) Act (bankruptcy provisions for financially distressed companies, also being re-written); 1992 Securities and Exchange Bureau of India (*SEBI*) Act (sets up SEBI, regulator of stock markets). For more discussion of the growth of Indian Industry since the beginning of the twentieth century see M.D. Morris, *The Growth of Large Scale Industry up to 1947*, *in* 2 CAMBRIDGE ECONOMIC HISTORY OF INDIA 553-676 (D. Kumar ed., 1983). For broader discussion, see AMIYA K. BAGCHI, PRIVATE INVESTMENT IN INDIA, 1900-1939 (1972); RADHE SHYAM RUNGTA, RISE OF BUSINESS CORPORATIONS IN INDIA, 1851-1900 (1970).

[8] *See* PURSHOTAMDAS THAKURDAS, J.R.D. TATA, G.D. BIRLA, ARDESHIR DALAL, SHRI RAM, KASTURBHAI LALBHAI, A.D. SHROFF & JOHN MATTHAI, THE "BOMBAY PLAN" FOR INDIA'S ECONOMIC DEVELOPMENT (1944) [hereinafter 1944 BOMBAY PLAN]. This is generally consistent with Roe's account of the importance of economic devastation in one's own territory. *See* Roe, *supra* note 4.

[9] *See* RAJESH CHAKRABARTI, THE FINANCIAL SECTOR IN INDIA: EMERGING ISSUES 196-219 (2006).

[10] *See* Omkar Goswami, *India: The Tide Rises Gradually*, *in* CORPORATE GOVERNANCE IN DEVELOPMENT 105 (C.P. Oman ed., 2003).

[11] *See* Rakesh Mohan & Vandana Aggarwal, *Commands and Controls: Planning for Indian Industrial Development, 1951-1990*, 14 J. COMP. ECON. 681 (1990). Some changes are

had a number of effects, but for our purposes, the most important effects occurred in four areas.

(i) **Limiting competition** — a number of policies served to limit domestic and foreign competition thereby reducing the competitive pressures to have better governance.

(ii) **Positioning the State as the primary capital provider** — a number of policies led to the state becoming the primary provider of capital (debt and equity) with incentives that led to little monitoring of a firm's management. This led to weakened governance.

(iii) **Hampering secondary capital providers in playing a governance role** — judicial delays and practices served to weaken the ability and incentives of secondary capital providers to monitor management.

(iv) **Insulating firms from the effects of weak governance** — a number of policies that kept failing firms afloat served to insulate firms from the effects of weak governance.

Any one of these effects would have had negative consequences for governance, but when combined these effects became a potent recipe for dysfunctional governance. Let us examine each of these effects in more detail beginning with policies that limited competition.

The government nationalized certain industries, becoming the sole provider of many goods and services, and removed private firms and competition from large sectors of the economy.[12] It also passed laws requiring industrial enterprises to obtain licenses to conduct business or to expand capacity (commonly known as the "license raj").[13] Nationalization, the increasing presence of state owned enterprises (SOEs),[14] and extensive licenses limited domestic competition while providing for rent seeking and corruption. Further, the government erected large trade barriers and tariffs along with limits on foreign investment in Indian enterprises, which served to limit foreign competition.[15] With domestic and foreign competition thus limited corporate governance was hindered as firms faced few competitive

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quite similar to the proposals in the 1944 BOMBAY PLAN, *supra* note 8. The plan appeared to become the blueprint for India's economic growth.

12 For some industries only the government could start new firms. *See* Goswami, *supra* note 10. There appeared to be great skepticism that private parties could reliably provide goods and services and concerns that private parties' incentives might be somewhat warped. *See* 1944 BOMBAY PLAN, *supra* note 8; CHAKRABARTI, *supra* note 9.

13 *See* Goswami, *supra* note 10.

14 The SOEs were not generally run to maximize profits (they had some other goals too) and hence did not have strong incentives to develop efficient governance. *See id.*

15 There were also rules requiring firms to obtain goods from indigenous firms/producers. *See id.*

pressures to be efficient. When this is combined with how many firms were capitalized, an unpalatable recipe for governance emerged.

The primary source of capital for many Indian firms at this time was debt capital. The state provided this through state-owned and operated development finance institutions (DFIs).[16] DFI employees were assessed on the total amount of loans made, rather than whether the firms they funded made a profit. This created an incentive to maximize the amount of loans, rather than monitoring firms to which DFIs provided loans.[17] Further, there were some non-DFI creditors, but their ability to monitor management was hampered by the glacial speed of India's bankruptcy process — it could easily take ten years to liquidate a firm.[18] This would have placed non-DFI creditors in an unenviable situation. Such weakened monitoring would further hamper governance.

The question then becomes might shareholders pick up some slack in monitoring? Here once again there were problems. First, the primary providers of equity capital were, again, the DFIs even though they seemed to prefer debt investment. DFIs might invest in equity when their internal debt ratios would prohibit them from investing any more as creditors.[19] DFIs often had well over fifty percent of the equity.[20] However, the DFIs had, as before, little incentive to monitor management and routinely appointed nominee directors that would rubber stamp management decisions.[21] There were also non-DFI shareholders who could rely on provisions in the Companies Laws to raise oppression and mismanagement concerns.[22] However, they were unlikely to have their grievances effectively redressed for a number of reasons.

First, the Indian judicial system was full of delays and years could pass before such litigation would be adjudicated.[23] Second, there appeared to be many irregularities in the share transfer and

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16 *See* CHAKRABARTI, *supra* note 9; FIN. & PRIVATE SECTOR DEV. UNIT S. ASIA REGION, WORLD BANK, INDIA: ROLE OF INSTITUTIONAL INVESTORS IN THE CORPORATE GOVERNANCE OF THEIR PORTFOLIO COMPANIES (2005), *availale at* www.nfcgindia.org/final_india-june29.pdf; Goswami, *supra* note 10.

17 DFIs may have favored incumbent managers for a variety of reasons including corruption, apathy, or political gain.

18 *See* T.C.A. Anant & Omkar Goswami, *Getting Everything Wrong: India's Policies Regarding "Sick" Firms*, *in* INDIAN INDUSTRY: POLICIES AND PERFORMANCE 236 (Dilip Mookherjee ed., 1995). Non-DFI creditors often did not provide credit except to large and well known firms or firms with the backing or guarantee of the government.

19 *See* Goswami, *supra* note 10.

20 *See id.*

21 *See id.*

22 *See* Indian Companies Act, 1956, § 209.

23 *See* Goswami, *supra* note 10.

registration process, which would have further delayed minority shareholders in bringing their cases.[24] Third, the disclosure of ownership structure and related party transactions was very opaque in India making it even harder for minority shareholders to achieve redress.[25] This was exacerbated by the very high tax rates for corporations and individuals, which led to a tremendous amount of tax evasion achieved by devising highly complicated cross-holding structures.[26] Finally, even if someone tried to buy up shares in the corporation, the government could block share transfers that might result in a change in the board that the government considered "prejudicial to the interest of the company or the public interest."[27] Given that government (via the DFIs) tended to vote with management, one can easily see how this would lead to entrenchment of management and little scope for effective oversight by other shareholders.

The weak monitoring generated by these features was compounded by the invidious role of capital structure. Because the DFIs provided so much of the capital (both in debt and in equity) the promoters could maintain control by providing only three percent of a firm's capital.[28] With so little invested in the firm the promoters and management had incentives that diverged quite widely from the rest of the shareholders. Indeed, the prospect for self-dealing and moral hazard would loom large in this environment.

Such a system should have led to considerable looting by management and many failed companies. Indeed, it did, but the system was insulated from some negative financial and employment consequences due to the slow bankruptcy process and the fact that the state could (and did) take over failing businesses and keep them afloat to maintain employment. The employment dislocation that would otherwise follow such policies did not immediately eventuate, but at the cost of increasing the effective debt burden for the state.[29]

Thus, by 1991 the Indian corporate scene had changed considerably from its pre-Independence situation. For SOEs the lack of competition and little profit incentive contributed to the inefficiency of the enterprise and of its atrophied corporate governance. For private firms corporate governance was ineffective for a number of reasons. First, the DFIs as large shareholders and creditors played little to no monitoring role given how their incentives were set up and the politi-

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24 *See id.*

25 *See id.*

26 *See id.*

27 *See* Indian Companies Act, 1956, § 309.

28 *See* Goswami, *supra* note 10.

29 *See* Anant & Goswami, *supra* note 18.

cal background against which they were to act. Second, the non-DFI creditors could exercise only limited oversight given the very slow pace of bankruptcy proceedings in India. Third, minority shareholders (non-DFI shareholders) faced considerable obstacles in enforcing their rights in court. Fourth, promoters could start firms by putting up only the smallest sliver of their own capital. When this is combined with the ineffective oversight by other parties, the potential for mismanagement and fraud becomes quite large. Moreover, these private firms faced little competitive pressure to improve their efficiency because of the "license raj" system, which limited domestic competition, and the high trade and other barriers, which limited foreign competition. Finally, the employment dislocation that might have been caused by very inefficient management leading to failed firms was not felt in its entirety because the state could take over failing firms and keep their workforce employed. This would have reduced the political cost of supporting inefficient management.

This is a recipe for dysfunctional corporate governance and that is precisely what India had. From the outside, India had the laws and the legal system to enforce corporate governance but the operation of the system, inconsistent disclosure, and largely ineffective boards of directors led it to be a failing system of governance. Indeed, Indian firms looking for capital had to rely primarily on internal sources or on the capital provided by the DFIs.[30]

C. Liberalization and Corporate Governance Reform (1991 to Present)

The sheer weight and cost of the overall economic and regulatory system came crashing down on the Indian economy in 1991 when the Indian government, in response to a financial crisis, embarked upon a general program of liberalization. Liberalization was to take the form of selling off some of the SOEs and beginning to sell off or rationalize the state's interests in other firms. Further, the DFIs were now to be assessed on "bottom line" measures rather than the amount of loans sanctioned.[31] Moreover, trade barriers were to be reduced, foreign investment permitted (and even encouraged), and the

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[30] *See* FIN. & PRIVATE SECTOR DEV. UNIT S. ASIA REGION, *supra* note 16; Asish Bhattacharyya & Sadhalaxmi Vivek Rao, Economic Impact of 'Regulation on Corporate Governance': Evidence from India, (2005), *available at* http://ssrn.com/abstract=640842.

[31] It appears that the DFIs no longer provided the subsidized access to funds that were present in the past and DFIs were at times merged with private entities. *See* FIN. & PRIVATE SECTOR DEV. UNIT S. ASIA REGION, *supra* note 16. The main DFIs prior to 1991 were: IFCI, ICICI, IDBI, UTI, LIC, GIC, and Public Sector Banks. Currently, there are three sets of institutional investors — new private sector mutual funds, foreign institutional investors and the remaining DFIs.

"license raj" to be eased thereby providing for increased domestic and foreign competition.[32] Following this the government created the securities market regulator — the Securities and Exchange Board of India (SEBI) in 1992 — and slowly granted it increasing powers and the mandate to regulate the stock markets in India.[33] This was also significant because SEBI could take on an adjudicatory role and thereby relieve some pressure off the court system and provide more timely resolution of disputes. These changes set the background against which India would enact corporate governance reforms.

II. Corporate Governance Reforms

The watershed event in Indian governance reform is generally perceived to be SEBI's promulgation of Clause 49 of the stock exchange listing agreement in 2000.[34] The path to Clause 49 began in 1998 when the Confederation of Indian Industry (CII) — a large industry association — proposed a voluntary code of corporate governance for Indian firms.[35] This was followed in quick measure by SEBI forming the Kumar Mangalam Birla Committee (KMBC) to suggest changes in the listing agreement of the stock exchanges to address corporate governance concerns. The KMBC's draft set of recommendations came out on October 1, 1999 and became effective as Clause 49 of the listing agreement with the exchanges on February 21, 2000 — a stunning five months later.[36] Firms failing to meet the requirements of Clause 49 could be de-listed.[37] The details of Clause 49 are provided in Appendix 1, but a brief overview is provided below.

Clause 49 had a number of requirements and recommendations and it provided a phased in implementation schedule wherein certain firms (e.g., Group "A" firms or larger firms) were expected to comply earlier than mid-sized firms which were expected to comply earlier than smaller firms. Clause 49's requirements included:

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32 *See* Goswami, *supra* note 10.

33 *See* Securities and Exchange Board of India Act, 1992.

34 The reforms started almost with the creation of SEBI in 1992, but some of the key regulations were the SEBI Takeover Code, 1997 (dealing with acquisitions of control primarily) and the SEBI Disclosure and Investor Protection Guidelines, 1999 (addressing public issuances of securities).

35 *See* Confederation of Indian Industry, Desirable Corporate Governance: A Code (1998).

36 *See* Report of the Committee Appointed by the SEBI on Corporate Governance Under the Chairmanship of Shri Kumar Mangalam Birla, *available at* www.nfcgindia.org/pdf/KumarMangalamb_report.pdf (1999).

37 Large financial and criminal penalties are available for violating Clause 49 under Section 23E of the Securities Contracts Regulation Act, 1956 (as amended in 2004).

(i) minimum percentages of independent directors (fifty percent or thirty-three percent depending on whether the Chairman was an executive director),

(ii) tightening up the definition of "independence,"

(iii) mandating the number of board meetings per year,

(iv) developing a code of conduct,

(v) imposing limits on the number of directorships a director could simultaneously hold,

(vi) enhancing the power of the audit committee by requiring financial literacy, experience, and independence of its members and by expanding the scope of activities on which the audit committee had oversight,

(vii) certifications by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of financials and overall responsibility for internal controls,

(viii) enhanced disclosure obligations (on many things including accounting treatment and related party transactions), and

(ix) enhanced requirements for holding companies when overseeing their subsidiaries.

These changes appear aimed at making boards and audit committees more independent, powerful, and focused monitors of management. Moreover, the enhanced disclosure would aid institutional and foreign investors in monitoring management as well. Clause 49 was received with much fanfare and has been the subject of many conferences, events, and debates on its reach, application, and interpretation.[38]

Following Clause 49 a number of further committees were formed which led to further changes in the listing requirements (e.g., Y.H. Malegam Committee, Narayana Murthy Committee, Naresh Chandra Committee).[39] Some of these changes came into effect in 2004. Also during 2004 the Indian government amended the Securities Contracts (Regulation) Act, 1956 wherein section 23E now imposed criminal penalties and larger financial penalties for violations of the listing agreement (up to Rs. 25 crores (roughly $5,000,000

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[38] For example, there is a website centered on Clause 49 at http://www.clause49.com/clause49.htm (last visited July 6, 2009).

[39] *See* REPORT OF THE COMMITTEE APPOINTED BY THE SEBI ON CORPORATE AUDIT AND GOVERNANCE UNDER THE CHAIRMANSHIP OF SHRI NARESH CHANDRA (2002); REPORT OF THE COMMITTEE APPOINTED BY THE SEBI ON CORPORATE GOVERNANCE UNDER THE CHAIRMANSHIP OF SHRI N.R. NARAYANA MURTHY (2003); REPORT OF THE COMMITTEE APPOINTED BY THE SEBI ON ACCOUNTING STANDARDS UNDER THE CHAIRMANSHIP OF SHRI Y. H. MALEGAM (2003).

U.S.) for a violation).[40] This was a significant increase in penalties from the initial penalty of de-listing for violations of Clause 49.

By 2005 amendments were being proposed to the Statutory Companies Law based on the J. J. Irani Committee's (2005) recommendations.[41] If adopted, the statutory law would permit greater customization and self-regulation (e.g., requiring shareholder approvals for executive compensation). Moreover, there would be greater protections for smaller shareholders, especially in merger transactions. Finally, the process of enforcement is to be streamlined, the bankruptcy system upgraded, and the actual legal provisions rationalized and simplified (eliminating redundancies and so forth). The changes will apply to all firms in India (not just those listed on the exchanges as with Clause 49). The proposed changes are summarized in Appendix 1 and compared to the changes wrought by Clause 49. These changes are not inconsistent per se with Clause 49 given that Clause 49 only applies to a subset of firms (listed firms) subject to the Irani committee's recommendations.[42]

Since 2005 there has not been much in the way of changes to either the listing agreement or the Statute, but in September 2007 SEBI initiated its first enforcement and investigation proceedings against firms for violations of Clause 49.[43] It is noteworthy that the first enforcement actions were brought nearly seven years after the promulgation of Clause 49 and, to date, no penalties have been imposed. This may change with the revelations about the Satyam fraud. Further, in the last few months, the Indian Cabinet has approved the Irani Committee's recommendations and statutory law changes may become visible in the near future.[44]

There are many important and perhaps remarkable features in the Clause 49 reform process. Notably, the reform process was initi-

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[40] Inserted by Securities Laws (Amendment) Act, 2004, § 11 (which took effect from Oct. 12, 2004).

[41] *See* JAMSHED J. IRANI, REPORT OF THE EXPERT COMMITTEE TO ADVISE THE GOVERNMENT ON THE NEW COMPANY LAW (2005). The corporate governance of banks was reformed, too. *See* CHAKRABARTI, *supra* note 9.

[42] Listed firms may raise capital from the general public, which raises additional concerns compared with firms that do not approach the general public for funds (i.e., private firms). The Irani committee's recommendations may reflect a different investment environment than when Clause 49 was enacted. India attracts more capital now than it did before Clause 49 (indicating that the marginal gain from governance reform now may not be as large) and there are many firms who have had difficulty in complying in a timely manner with Clause 49, indicating that further reform may be fairly costly on top of the reforms in Clause 49.

[43] *See* Ashish Rukhaiyar, *Navratnas Join Listing Rule Violators*, ECON. TIMES, Sept. 13, 2007; *SEBI Pulls up 20 Clause 49 Violators*, ECON. TIMES, Sept 12., 2007.

[44] *See Cabinet Approves Companies Bill*, TIMES OF INDIA, Aug. 30, 2008.

ated and supported by private industry (i.e., the CII) rather than triggered by an Enron-like scandal.[45] This is somewhat unusual because governance reform tends to place constraints on what managers and controlling shareholders can do. Given that these people make up the power structure of Indian industry it seems odd that they would support placing constraints on themselves without the issues raised by a scandal.

However, in India, industry pushed for governance reform because access to capital was necessary to take advantage of the opportunities created by liberalization and to stay ahead of (or at least with) the competition.[46] Obtaining capital from domestic and foreign investors would have been difficult without some greater assurances (given the poor track record of the capital markets since independence and the debilitated state of governance).[47] Moreover, given the likely low level of interest from domestic investors, industry may have had to approach foreign investors for the bulk of their funding initially. The CII voluntary code appears, in many respects, designed to attract foreign investors to Indian firms as many of its provisions were based on "best practices" at the international level.[48]

However, the voluntary code was not perceived to have generated a very high level of foreign investor interest or domestic compliance. Enacting the CII code as law might be necessary to bolster the credibility of governance reform.[49] Indeed, we see CII lobbying SEBI to enact some governance reform less than a year from the announcement of its voluntary code.[50] Presumably, making governance part of the law would enhance its credibility and probably provide some en-

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[45] *See* Goswami, *supra* note 10. Although India has had stock market scandals over the years, none of them seemed to initiate the Clause 49 reforms. These scandals usually involved misdealings by brokers and traders rather than the more standard corporate governance concerns. *See id.*

[46] *See id.*; *see also* CHAKRABARTI, *supra* note 9.

[47] *See* Goswami, *supra* note 10.

[48] This bears some similarity to how the stock markets in the United States developed. *See* John C. Coffee Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001). However, in India the larger growth of the stock markets occurred after the law was enacted (and not just after voluntary measures like the CII Code).

[49] *See* Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, J. FIN. ECON. (forthcoming 2009); John C. Coffee Jr., *Law and the Market: The Impact of Enforcement*, (Columbia Law Sch. Ctr. for Law & Econ. Studies Working Paper No. 304, 2008), *available at* http://ssrn.com/abstract=967482; Robert Daines & Charles Jones, Mandatory Disclosure, Information Asymmetry and Liquidity: The Effect of the 1934 Act, (January 2007), *available at* http://www.law.yale.edu/documents/pdf/CBL/34_Yale.pdf.

[50] *See* Abhinaba Das, *CII to Urge SEBI, BSE to Make Corporate Governance Must for Listings*, INDIAN EXPRESS, May 5, 1999.

forcement for it. Thus, the corporate governance reform movement was motivated by a desire to raise capital from foreign investors to fund investment in new business opportunities or to enhance chances in current endeavors. With industry, the primary opposition to reforms normally, supporting them it is not surprising that the reforms came swiftly.[51] Reform was also supported by the increasing presence of foreign investors, the Indian financial press being quite active, and the desire to access U.S. capital markets.[52]

Another important feature of the Clause 49 reform process was the gradual escalation of sanction severity. Initially, the penalty for non-compliance was de-listing (2000), then some years later more severe financial penalties became available (2004), and then finally enforcement actions some years later (2007-08). Although there could be a number of explanations for this approach,[53] the weak sanctions and enforcement in India stand in contrast to many other countries that engage in law reform and start with *strict enforcement* to attract investors.[54] One suspects that these countries must do this because the motivation for the reforms is some large-scale fraud (e.g., Enron) which may then necessitate visible enforcement actions to restore investor confidence. However, in India visible enforcement actions were probably not as necessary to attract investors because such scandals were not the immediate reason for promulgating the reforms. Indeed, industry support for the reforms may have even lessened the pressing need for enforcement to convey that changes in governance were more credible.

III. Effects of the Reforms?

Having described the Clause 49 reforms the next natural question becomes what effects have these reforms had? There are a handful of studies examining the impact of corporate governance reforms in India. The tenor of these studies is that the Clause 49 reforms were received positively by the market.

Dhammika Dharmapala and I recently conducted an empirical analysis of the causal effect of the governance reforms (i.e., Clause 49

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51 *See* Bernard S. Black & Vikramaditya Khanna, *Can Corporate Governance Reforms Increase Firms' Market Values?: Evidence from India*, 4 J. Empirical Legal Stud. 749 (2007).

52 *See* Goswami, *supra* note 10.

53 These could include grandfathering in existing firms, ameliorating potential opposition to the reforms, and granting SEBI discretion on enforcement. For greater discussion see Vikramaditya Khanna, An Anatomy of Corporate Governance Reform: The Case of India (draft paper 2009) (on file with author).

54 *See* Jackson & Roe, *supra* note 49; Coffee *supra* note 49; Daines & Jones, *supra* note 49.

and certain associated reforms) on measures of firm value.[55] Certain features of the reforms allowed us to conduct a series of empirical tests that address the issue of whether the reforms *caused* increases in firm value.[56] We find that indeed the reforms appear to have caused substantial increases in firm value. Moreover, the reforms in 2004 (the increase in penalties) appeared to matter even more to firm value than the substantive reforms enacted in 2000, underscoring the value of enforcement and sanctions.[57] When we probed further into what aspects of governance might matter most (reducing the risk of controllers expropriating assets, reducing managerial slack) our results were not conclusive, perhaps because we had only two years of data after the 2004 reforms (our data ended in 2006). However, the key results — reforms *causing* increases in firm value and the importance of enforcement — are important for beginning to understand the impact of the reforms.[58]

There are many questions raised by these findings — are governance practices actually changing in India, what does the absence of enforcement indicate, and what can we learn about appropriate governance rules? Some of these questions are beginning to be explored.

Recently, Bala Balasubramanian, Bernard Black, and I conducted a detailed survey of the corporate governance practices of Indian firms.[59] The survey obtained responses from 370 large, medium, and small firms (a seventy-three percent response rate) in 2006 and it will be replicated for two further years. The survey's goals were to describe what governance looks like in India and to assess whether

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[55] *See* Dhammika Dharmapala & Vikramaditya Khanna, *Corporate Governance, Enforcement, and Firm Value: Evidence from India* (Univ. of Mich. Law & Econ. Olin Working Paper No. 08-005, 2009), *available at* http://ssrn.com/abstract=1105732.

[56] *See id.* The rules for application of the reforms were such that they created treatment and control groups with overlapping characteristics. Further, the reforms limited the ability of firms to opt out of the reforms and few firms appeared to opt in to the reforms thereby limiting self-selection concerns. Using these rules, a sample of over 4000 firms and a difference-in-difference analysis we found a large and statistically significant positive effects of the Clause 49 reforms in conjunction with the 2004 sanctions on firm value. This result holds through a series of robustness checks and a regression discontinuity analysis. *See id.*

[57] The similarity of Clause 49 to the Sarbanes-Oxley Act (SOX) is striking, but the positive effects of Clause 49 in India do not mean that SOX is similarly beneficial in the United States — that depends on many other factors including, importantly, institutional context. *See* Black & Khanna, *supra* note 51.

[58] Black and Khanna conduct an event study of the adoption of Clause 49. *Id.* They rely on Clause 49's phased implementation schedule and find positive returns to a treatment group of large firms relative to a control group of small firms, around the first important legislative announcement.

[59] *See* Bala N. Balasubramaniam, Bernard S. Black & Vikramaditya Khanna, *Firm-Level Corporate Governance in Emerging Markets: A Case Study of India* (Univ. of Tex. Law Sch. Law & Econ. Research Paper No. 87, 2009), *available* at http://ssrn.com/abstract=992529.

better governance practices are associated with better firm performance.

On the first issue — what governance looks like — we find that:

(i) Most but not all responding firms meet the board independence rules under Indian law.[60]

(ii) Most but not all firms have the legally required audit committee; many have a (legally required) audit committee member with financial or accounting expertise.

(iii) Related party transactions are common, but approval requirements for them are often weak.

(iv) Only about two-thirds of firms provide annual reports on their websites.[61]

(v) Executive compensation is modest by U.S. standards, but CEOs face only a small risk of dismissal.

(vi) Only about three-fourths of firms allow voting by mail, even though this has been legally required since 1956.

(vii) Government enforcement is rare.

On the second issue we found that firms with better governance were associated with higher firm value. We further found that this association extends to and may be even stronger for smaller firms. Most of the earlier multi-country studies did not find this because they focused only on the largest firms in each country (where they did find an association between governance and firm value for these large firms).[62] Second, we also found that more profitable firms and faster growing firms seem to have a stronger association between governance and firm value. Finally, we examined a number of different aspects of governance and we found, unlike other studies, little association between board structure and firm market value.[63] However, India's board structure requirements are higher than in many

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[60] *See id.* About eighty-seven percent of responding private Indian firms complied with rules requiring either fifty percent independent directors on the board or one-third independent directors and a separate CEO and board chairman. The board chairman often represents the controlling business group or other controlling shareholder.

[61] For those firms that do not provide their annual reports there is not another really good alternate source.

[62] *See, e.g.*, Artyom Durnev & E. Han Kim, *To Steal or Not to Steal: Firm Attributes, Legal Environment, and Valuation*, 60 J. FIN. 1461 (2005); Leora F. Klapper & Inessa Love, *Corporate Governance, Investor Protection and Performance in Emerging Markets*, 10 J. CORP. FIN. 703 (2004).

[63] *See* Jay Dahya, Orlin Dimitrov & John J. McConnell, *Dominant Shareholders, Corporate Boards, and Corporate Value: A Cross-Country Analysis*, 87 J. FIN. ECON., 73 (2008); Bernard S. Black & Woochan Kim, *The Effect of Board Structure on Firm Value: A Multiple Identification Strategies Approach Using Korean Data*, (Univ. of Tex. Law Sch. Law & Econ. Research Paper No. 89, 2009), *available at* http://ssrn.com/abstract=968287.

other countries and thus, going beyond the legal requirements may not influence market values much.

These findings seem to suggest (when combined with studies on other countries) that the benefits of certain governance practices vary with firm and country characteristics. Indeed, governance does not appear to be one-size fits all.[64] Thus, some degree of variation in governance rules for different kinds of firms may be desirable. For example, combining some mandatory minimum rules (that may vary on firm size) with flexibility above the minimum — such as allowing firms to comply or to explain why they are not complying with governance rules (as in the U.K. and Continental Europe)[65] or to self select which level of governance they will abide by (as in Brazil)[66] — may prove more valuable than legal regimes relying primarily on mandatory rules. Indeed, just recently SEBI has put forward a discussion paper on setting up separate rules for small and medium sized enterprises.[67]

Of course, many questions remain for inquiry. Even though firms appear to be increasingly complying, one wonders why. There appears to be little enforcement, which suggests that other forces (e.g., market forces, reputational concerns, or anticipation of enforcement)[68] may be playing an important role. This is a matter that merits greater inquiry. Further, even assuming good compliance one wonders why the reforms would be received positively. The rules appear designed to address concerns one sees with dispersedly held firms typified by the agency problem between managers and shareholders, yet most Indian firms are controlled (family) firms where the larger agency problem is usually between controlling shareholders and minority shareholders. Indeed, there has been evidence of con-

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64 *See also* Sridhar R. Arcot & Valentina Giulia Bruno, One Size Does Not Fit All, After All: Evidence from Corporate Governance (Jan. 15, 2007), *available at* http://ssrn.com/abstract=887947; Valentina G. Bruno & Stijn Claessens, *Corporate Governance and Regulation: Can There Be Too Much of a Good Thing?*, (European Corporate Governance Institute Finance Working Paper No. 142/2007, 2007), *available at* http://ssrn.com/abstract=956329.

65 *See* Arcot & Bruno, *supra* note 64.

66 *See* Erica Gorga, Changing the Paradigm of Stock Ownership: From Concentrated Toward Dispersed Ownership? Evidence from Brazil and Consequences for Emerging Markets, (Sept. 2008), *available at* http://ssrn.com/abstract=1121037.

67 *See* SEBI, Discussion Paper on Developing a Market for Small and Medium Enterprises in India (2008), *available at* http://www.sebi.gov.in/commreport/sme.pdf

68 Given that most of the Clause 49 reforms were already present in the CII voluntary code it would appear that it was not simply the actual provisions per se that were valuable, but the threat of enforcement (or a signal from it) the law provided via Clause 49. If the provisions themselves were all that mattered then industry would have been able to raise the desired level of capital with the voluntary code. The presence of the same provisions in a law seemed to matter quite a lot, suggesting that enforcement was critical.

trollers expropriating minority shareholders in India.[69] Thus, how these rules may benefit firms in India is a matter that merits further investigation.

All of this suggests that much more inquiry is needed to gain a fuller appreciation of the effects and implications of governance reform in India. Indeed, recent events in India surrounding the Satyam fraud raise many questions about whether the reforms are useful in the Indian context and whether the compliance is simply on "paper" as opposed to genuine. I now turn to discuss some issues associated with these concerns.

IV. Satyam Scandal & Future of Governance Reform in India

The recent revelations of fraud at Satyam — a perceived corporate governance leader — raise many questions about corporate governance in India.[70] Although important facts are still coming to light, it appears that the fraud, at its core, involved an astonishing overstatement of Satyam's profits and assets.[71] By admission from the chairman and founder of Satyam, B. Ramalingam Raju, the profits and assets of the firm were overstated by as much as ninety percent

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69 Khanna, Kogan, and Palepu study instances of minority shareholder expropriation by Indian firms and Bertrand, Mehta, and Mullainathan provide evidence on tunneling within Indian business groups. *See* Marianne Bertrand, Paras Mehta & Sendhil Mullainathan, *Ferreting Out Tunneling: An Application to Indian Business Groups*, 117 Q. J. Econ. 121 (2002); Tarun Khanna, Joe Kogan & Krishna G. Palepu, *Globalization and Similarities in Corporate Governance: A Cross-country Analysis*, 88 Rev. Econ. & Stat. 69 (2006). Dharmapala and Khanna examine whether the tunneling risk within Indian business groups changed after Clause 49. Their initial evidence indicates that tunneling dropped to low levels around the announcement of the substantive reforms (1999-2000) and has essentially stayed there since then. Of course, there are other methods of insider expropriation besides tunneling within business groups, but those are not measured by the Dharmapala and Khanna study. *See* Dharmapala & Khanna, *supra* note 55.

70 *See Satyam to be Stripped off Golden Peacock Award*, Indian Express.com, Jan. 7, 2009, http://www.indianexpress.com/news/satyam-to-be-stripped-off-golden-peacock-awa/407831/.

71 For a brief summary of the Serious Fraud Investigation Office's findings into Satyam see Richa Mishra, *Satyam Scam: SFIO Finds Auditors Guilty*, Hindu Bus. Line, May 3, 2009, *available at* http://www.thehindubusinessline.com/2009/05/03/stories/2009050351120300.htm. Satyam's auditors do not appear in a positive light and Satyam's independent directors are described as "mute spectators in the entire process." *See* Souvik Sanyal & Dheeraj Tiwari, *Satyam Diverted Foreign Earnings: SFIO*, Econ. Times, Apr. 20, 2009, *available at* http://economictimes.indiatimes.com/articleshow/4422469.cms. The SFIO report is apparently about 12,000 pages long. *See* Sapna Dogra Singh, *SFIO Concludes Satyam Probe*, Bus. Standard, Apr. 15, 2009, *available at* http://www.business-standard.com/india/news/sfio-concludes-satyam-probe/355140/.

(over 1 billion U.S. dollars).[72] The reaction to this news was swift and severe with Satyam's stock plummeting and various arms of government commencing investigations. Some of Satyam's top executives were soon arrested which was followed by the arrest of some members of Satyam's auditor, Price Waterhouse Coopers.[73] The immediate reaction to the Satyam fraud was to label it India's Enron, which was then accompanied by a chorus for governance reforms.[74] Is Satyam really India's Enron, what does it tell us about corporate governance in India, and what steps might be desirable to take to prevent this kind of wrongdoing from happening again?

As a starting point, the similarities between Satyam and Enron may be more superficial than real. Satyam — like Enron — is a well-publicized fraud involving gross misstatement of financial performance, but that is where the similarities begin to fade. First, Enron was not a fraud at one firm but a series of frauds at a number of U.S. firms that shared some similarities. So far, Satyam is the only firm with reported fraud of this nature in India. Thus, the extent to which Satyam reflects a system-wide concern is limited. Second, Satyam appears to be a fraud orchestrated by its controlling shareholder (promoter) allegedly involving the expropriation of assets.[75] The Enron series of frauds usually involved management trying to camouflage losses primarily occasioned by bad business decisions.[76] The perpetrators of wrongdoing and often the kind of wrongdoing are different.[77] Indeed, the agency problem in Satyam seems more aligned

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[72] *See* Letter from B. Ramalinga Raju, Chairman, Satyam Computer Services Ltd., to Board of Directors, Satyam Computer Services Ltd. (Jan. 7, 2009), *available at* http://blogs.livemint.com/blogs/initial_private_opinion/Satyam_Conf.pdf.

[73] *See* Harichandan Arakali & Saikat Chatterjee, *Price Waterhouse Auditors Arrested in Satyam Inquiry*, BLOOMBERG.COM, Jan. 24, 2009, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=a5sa8Cqwaa_Q&refer=home.

[74] *See* Ashok Dasgupta, *Satyam is India's Enron*, HINDU, Jan. 8, 2009, *available at* http://www.hindu.com/2009/01/08/stories/2009010859951500.htm; T.T. Ram Mohan, *India's Enron*, FORBES, Jan. 8, 2009, *available at* http://www.forbes.com/2009/01/08/satyam-raju-auditors-oped-cx_rm_0108mohan.html.

[75] It is noteworthy that Raju's family had a diminishing stake in Satyam for much of the fraud period, eventually declining to less than six percent by January 2009. *See* C.P. Chandrasekhar, *The Satyam Scam: Separating Truth From Lies*, HINDU, Jan. 14, 2009, *available at* http://www.thehindu.com/2009/01/14/stories/2009011455800800.htm. The fact that such a fraud could be conducted by someone with this little in the firm raises interesting questions about both how the fraud occurred and deference to the founder of the firm. We will need to wait for more facts to come to light to say more.

[76] *See* John C. Coffee Jr., *A Theory of Corporate Scandals: Why the U.S. and Europe Differ* (Columbia Law Sch. Ctr. for Law and Econ. Stud., Working Paper No. 274, 2005), *available at* http://ssrn.com/abstract=694581.

[77] Indeed, the fraud at Satyam appears to bear greater similarity to the fraud at Parmalat (in Italy) rather than Enron. As we shall see this may have implications for what kinds of steps we may take in response.

with the majority-minority shareholder conflict rather than the Enron series of frauds, which seem more aligned with the manager-shareholder conflict.[78]

Even if Satyam is not exactly India's Enron we may still be able to learn important lessons about governance in India from it as well as using it as a springboard to consider governance reforms. The first thing that may be worth noting is that it is often difficult to prevent all fraud. Satyam was not only subject to Indian governance rules, but also a number of U.S. governance rules due to its cross-listing in the United States (including provisions of the Sarbanes-Oxley Act).[79] Further, it had world-class independent directors and one of the best-known audit firms, Price Waterhouse Coopers. This highlights that fraud may still occur in spite of very detailed regulation fraud (in India, the United States or anywhere). It is probably unlikely that we can have rules that will eradicate fraud at an acceptable cost — sometimes the cost of policing fraud may exceed the cost of the fraud. Moreover, independent directors are not at the firm every day and often receive much of their information from management itself. In light of this we should not expect them to operate like a private detective. With that dose of realism in mind, let us examine what steps might have been able to prevent the Satyam fraud.

Satyam involves fraud in financial statements suggesting that those who are involved in the creation of these statements may have been able to prevent these misstatements (e.g., Satyam's auditors, its audit committee, and its majority independent board). However, none of these organs picked up on the misstatements. This can be contrasted to the more active role of those who had little involvement in the production of Satyam's financial statements. Indeed, calls for concern were first raised by Satyam's shareholders and the Indian media, which began raising questions about the dealings at Satyam, especially a proposal whereby Satyam was to purchase a related firm, Maytas.[80]

This provides evidence for both optimism and pessimism in Indian governance. Optimism because shareholders seem attentive and willing to voice their concerns, which in the longer run will be very

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[78] *See* Coffee, *supra* note 76; Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21 NAT. L. SCH. IND. REV.(forthcoming 2009), *available at* http://ssrn.com/abstract=1331581. This is underscored by the fact that Satyam was also subject to SOX, which was enacted in response to the Enron series of frauds, and yet the fraud occurred.

[79] *See* Varottil, *supra* note 78; Sudhakar V. Balachandran, *The Satyam Scandal*, FORBES, Jan. 7, 2009, *available at* http://www.forbes.com/2009/01/07/satyam-raju-governance-oped-cx_sb_0107balachandran.html.

[80] *See* Amit Garg, *Lessons from the Satyam-Maytas Deal*, HINDU BUS. LINE, Dec. 22, 2008, *available at* http://www.blonnet.com/ew/2008/12/22/stories/2008122250110400.htm.

important to the development of governance in India. Pessimism because those who were expected to police behavior at Satyam failed. This latter point, however, is where discussions for reform may be centered.

We begin with a question: why did the independent board, audit committee and auditors fail? These actors are expected to monitor the behavior of managers (at dispersedly held firms) and controllers/promoters (at controlled firms). Satyam had a controlling shareholder, like most Indian firms, and the board, audit committee, and auditors should have been monitoring that shareholder. However, as is common with most controlled firms, it was the controlling shareholder who essentially appointed the independent board and audit committee and selected the auditor. Although one does not doubt the independence and expertise of the board members at Satyam, one wonders whether this is the best way to appoint "independent" directors. After all, this is a structure where the actors who are supposed to monitor the controller were selected by her or him. In light of this reforms may focus on a number of issues including (i) the process for selecting directors, audit committee members, and auditors; (ii) the access to information these actors may have; and (iii) measures to ensure that these actors remain independent.[81]

(i) **Selection of actors:** To enhance independence one might consider granting minority shareholders greater say in appointing these actors (e.g., via a default provision for proportional representation, supermajority approvals for directors, or cumulative voting)[82] or attempting to add another layer of independence to the selection process by having an independent nominating committee select these actors. Additionally, one might consider allowing institutional investors to propose an alternate slate of directors to those put forward by the controlling shareholders. This may be particularly useful given how active shareholders were in the Satyam context. The goal would be to take some of the power to select these actors away from the controller.[83] Of these options such a result seems least likely with an inde-

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[81] These recommendations emanate in many ways, although not exclusively, from a conference on Satyam in February 2009 in New York City supported by Jindal Global Law School. *See also* Ajay Shah, *Getting the Right Architecture for Corporate Governance*, FIN. EXPRESS, Jan. 13, 2009, *available at* http://www.mayin.org/ajayshah/MEDIA/2009/ushaped.html (further discussing steps one might take for governance in the Indian context).

[82] "Default" here means that shareholders could contract around this (whether by simple majority voting or supermajority voting).

[83] We would not want to deprive the controller from having some say, because she or he has access to more information than most other players and hence may make more informed decisions. Further, we do not want to replace abusive controller behavior with abusive minority shareholder behavior.

pendent nominating committee if the controller also selects that committee. However, one could imagine combinations as well — an independent nominating committee that itself is created via proportional representation and then proceeds to nominate people as independent directors and so forth. Greater debate amongst these options is worthy of consideration.

(ii) **Access to information:** To allow actors to fulfill their roles they must have access to relevant, accurate and timely information. There are a number of measures one might consider to obtain this, including allowing the audit committee to meet auditors and other experts without the presence of the controller, allowing independent directors to hire special advisors, and so forth.[84]

(iii) **Measures to maintain independence:** Our goal is to ensure that actors who are considered independent continue to be so and have incentives to maintain both rigor and independence. Steps that may be taken in this direction include ensuring that the audit committee (or an independent group), rather than the controller, should appoint the auditor; auditors (or audit partners) should rotate out of a firm after a few years; there should be some oversight from other auditors (or a body of auditors); fiduciary duties of controllers should be extended to and enforced against other shareholders; and civil liability should be possible for auditors who are either complicit with controllers or are grossly derelict in their duties. Some measures on this front seem particularly important in light of Satyam where the misstatements involved assets that were very easy to verify. One might explore civil liability (either enforced by SEBI or private parties in a class action) along with the criminal liability that appears to currently exist. Although India does not currently have the kind of class action needed for private litigation, something like it has been suggested in the Irani Committee report. Nonetheless, allowing private litigation would raise concerns with constraining frivolous litigation. Moreover, private litigation involves using the court system, which could be delay-ridden and cumbersome. Public civil liability may be particularly important in this context.[85]

Although the reforms noted above may indeed have beneficial effects, the crucial question will be how will the laws — whether the current or new ones — be enforced? That is a matter we are likely to get some insight into as the Satyam case progresses and as other enforcement actions get commenced in the market downturn.

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84 The advisors would be paid for by the firm but selected and retained at the discretion of the directors.

85 For a broad discussion of the importance of enforcement, *see* Jackson & Roe, *supra* note 49.

Further, the reforms and enforcement in response to Satyam may also take second place to the likely reforms that may emanate from the Government of India as it continues its regulatory and legislative reform process in India's financial markets. There are a number of items on the agenda ranging from reform of the corporate and public debt markets,[86] to pension reforms,[87] to ambitions to make Mumbai an international financial center.[88] All these items are likely to require changes to legislation and regulation that will most likely have important effects on governance in India. Indeed, they may also be influenced by governance standards in India. Weaker governance may make it easier for corruption to flourish, which may serve to weaken the effects of the reforms noted above.[89] The relationship has symbiotic aspects to it. Indeed, the next few years will be important in the development and refinement of Indian corporate governance — something that we shall await with bated breath.

V. Conclusion

Corporate governance reform has become a worldwide phenomenon with India being one of the many countries that has amended its governance rules. The key first steps included the promulgation of a voluntary corporate governance code by the Confederation of Indian Industry and then the enactment of Clause 49 of the listing agreement at the turn of the millennium. These changes brought into India many of the international best practices of the time (e.g., independent boards, enhanced disclosure, shareholder rights) and appeared to be received positively by the market. These reforms were designed to attract foreign capital to India and appeared to succeed as well as appearing to cause increases in firm value for firms subject to the reforms. However, enforcement of these reforms has been fairly

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86 *See* Establishing a National Treasury Management Agency, Report of the Internal Working Group on Debt Management, 2008 (2008), *available at* http://finmin.nic.in/reports/Report_Internal_Working_Group_on_Debt_Management.pdf.

87 *See* Ajay Shah, *Indian Pension Reform: A Sustainable and Scalable Approach*, *in* Managing Globalisation: Lessons from China and India, ch. 7 (David A. Kelly, Ramkishen S. Raj & Gillian H.L. Goh eds., 2006), *available at* http://www.mayin.org/ajayshah/PDFDOCS/Shah2005_sustainable_pension_reform.pdf.

88 *See* Ministry of Fin., The High Powered Expert Committee on Making Mumbai an International Financial Centre (2007), *available at* http://finmin.nic.in/mifc.html; Planning Comm'n, Gov't of India, A Hundred Small Steps, Report of the Committee on Financial Sector Reforms (2009), *available at* http://www.planningcommission.gov.in/reports/genrep/rep_fr/cfsr_all.pdf.

89 *See* Vikramaditya Khanna, *New Centres of Economic Power — New Challenges and Priorities for Fighting Corruption? Corporate Governance, Corporate Integrity in India*, *in* Global Corruption Report 2009: Corruption and the Private Sector (Transparency Int'l ed., forthcoming 2009).

weak with no sanctions imposed yet. Surprisingly, compliance with the new (un-enforced) reforms was reasonably good. In some surveys compliance rates have been almost fifty percent or more at times. This suggests there is some degree of market incentive to comply as well as an appreciation that enforcement would come eventually.

Recent developments — such as the Satyam scandal — have brought greater attention to the governance situation in India. Although the Satyam scandal was dramatic, it did not suggest a general malaise in Indian corporate governance.[90] However, it was an opportunity to reassess where Indian corporate governance was and what reforms may prove beneficial in the future. A number of potential reforms were sketched out including reducing the influence of controlling shareholders in selecting their monitors, enhancing liability for auditors, rotating auditors, and granting directors and committee members more direct access to information about the firm. However, without enforcement these suggestions may not amount to much. Observing the enforcement actions in the Satyam context will prove very instructive. Indeed, moving forward the likely reforms to India's financial and corporate laws may have very broad and long-ranging effects on Indian corporate governance while India's governance regime may influence these same broader reforms. The next few years are likely to be pivotal in the regulation of the Indian financial and business markets. There is much to happen and much to learn.

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90 This is not meant to suggest that governance is wonderful at all Indian firms, but rather that the scale of fraud at Satyam does not appear to be present at many other large Indian firms.

APPENDIX 1: COMPARING CLAUSE 49 AND THE J.J. IRANI COMMITTEE RECOMMENDATIONS

Characteristic	Clause 49	J.J. Irani Committee
Independence	• Requirement – 50% independent directors if Chairman is executive director or 33% if Chairman is not. • Definition - not related to Board or one level below Board and audit partners must have no prior relationship with the Company for the last 3 years. • "Material" - no requirement for the relationship to be "material." • Financial institutions - are considered independent.	• Requirement – 33% for companies with public interest. • Definition - not related to employees of the Company and no prior relationship with the Company for one year. • "Material" - board to review on an on-going basis. • Financial institutions - not considered independent.
Board Requirements & Limitations	• Meet 4 times a year (maximum gap of 3 months between meetings) • Limits on number of committees a director can be on (10), but only 5 for which director can be chair of committee. • Develop Code of Conduct.	• Meet 4 times a year (maximum gap of 4 months between meetings). • Limits of number of directorships (15).
Audit Committee Composition	• At least 3 directors (two-thirds must be independent). • All financial literate. • At least one having accounting or financial management experience.	• No minimum number of directors (majority need to be independent). • No requirements for financial literacy. • At least one should have accounting/financial management knowledge.
Audit Committee Role & Powers	• Audit Committee Meetings — 4 meetings (gap between meetings not exceed 4 months). • Audit Committee role is broad — review statutory and internal auditors as well as internal audit function.	• Audit Committee Meetings — number not specified.

Disclosures	• Related party transactions. • Accounting treatments and departures. • Risk management. • Proceeds from offerings. • Compensation for directors (including non-executives and obtain shareholders' approval). • Details of compliance history for last 3 years. • Corporate governance reports (and disclose adoption, if any, of mandatory and non-mandatory requirements).	• Related party transactions. • Executive compensation. • Unusual transactions. • Director's background.
Certifications	• <u>CEO & CFO:</u> ▪ Financial statements. ▪ Effectiveness of internal controls. ▪ Legal transactions. ▪ Inform audit committee of any significant changes in the above. • <u>Auditor or Company Secretary:</u> ▪ Compliance with corporate governance	• <u>CEO, CFO & Company Secretary</u> ▪ Financials. • <u>CEO and CFO:</u> ▪ Internal controls (with audit committee approval).
Subsidiary Companies	• At least one Independent director of Holding Company should sit as a director on Board of material non-listed Indian subsidiary. • Significant transactions report to Holding company Board (along with subsidiary board's minutes).	
Other	• Whistleblower policy is optional. • Independent directors lose status as "independent" if served 9 years at company. • Training board members. • Evaluate non-executive board performance.	• Whistleblower policy and protection for whistleblower is encouraged.