Standing Committee on International
Financial Standards and Codes:
Advisory Group on Corporate Governance

Chairman

601, Neat House,
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Prabhadevi,
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Mumbai - 400 028.

March 24, 2001

Dear Dr. Reddy,

Standing Committee on International
Financial Standards and Codes:
Advisory Group on Corporate Governance

Please refer to your letter dated May 25, 2000 regarding the constitution of the captioned Advisory Group. I have great pleasure in forwarding herewith the Report of the Advisory Group on Corporate Governance. The Group has attempted to compare the status of corporate governance in India vis-à-vis internationally recognised best practices and standards and has listed out suggestions to improve corporate governance standards in India.

The Group studied the various models of corporate governance in the developed and the newly industrialised countries and also compared the legal and regulatory framework of corporate governance obtaining in India vis-à-vis international best practices. In this regard, the Group took into account the OECD (Organisation for Economic Co-operation and Development) principles, recommendations of Cadbury Committee, corporate governance principles in U.S. U.K. (London Stock Exchange Combined Code), European countries, East Asian countries as international models available. The Group also studied the recommendations of the committee appointed by Securities and Exchange Board of India in India. Considering the dominant role played by the public sector entities in India, the Group studied the practices prevailing in the central and state public sector enterprises falling under Companies Act. The Group also studied the corporate governance practices in banks and financial institutions in the financial sector in the light of BIS standards as it has major monetary and financial implications.

The recommendations of the Group cover, inter alia, responsibilities of the board of directors, accountability to shareholders/stake holders, criteria for selection of independent members of the board, size and composition of the board, appointment of committees of the board such as audit committee, nomination committee, remuneration committee and investment committee, disclosure and transparency of information and data, and the role of shareholders in a company.

The Group takes this opportunity to place on record its sincere thanks for all your valuable support extended to it.

With kind regards,

Yours sincerely,
Sd/-
(R. H. Patil)

Dr. Y.V. Reddy,
Deputy Governor,
Reserve Bank of India,
Central Office,
Mumbai - 400 001.

Corporate Governance and International Standards

Introduction

The Standing Committee on International Financial Standards and Codes (Chairman: Dr.Y.V.Reddy) constituted the Advisory Group on "Corporate Governance" (Chairman Dr. R.H. Patil) in the background for evolving sound standards based on recognised best practices and for adopting transparency while adhering to the codes. The other members of the Group are Dr. V. V. Desai, Sarvashri Deepak M. Satwalekar, M.G. Bhide, Nandan Nilenkani and Rajendra P. Chitale. The terms of reference of the Advisory Group are as follows:

(i) To study present status of applicability and relevance and compliance in India of the relevant standards and codes,
(ii) To review the feasibility of compliance and the time frame within which this can be achieved given the prevailing legal and institutional practices in India,
(iii) To compare the level of adherence in India, vis-à-vis in industrialized countries and also the emerging economies particularly to understand India's position and prioritise actions on some of the more important codes and standards,
(iv) To chalk out a course of action for achieving the best practices, and
(v) To help sensitise the public opinion on the above matters through its reports.

This Advisory Group held five meetings. The Group has discussed models of corporate governance prevailing in industrialised and emerging countries, the current status of the corporate governance in India in the private sector companies, the public sector companies set up under the Companies Act, and the banks and financial institutions (FIs) vis-à-vis the internationally accepted principles, codes and best practices in the areas of corporate governance. The Group adopted the OECD Principles of Corporate Governance as the main benchmark for comparing the extent of compliance by the Indian corporate entities. The Group has relied on (a) the Combined Code of London Stock Exchange, which was derived by its Committee on Corporate Governance, the Cadbury Report and Greenbury Report and (b) the Blue Ribbon Committee set up by NASD and NYSE on improving the effectiveness of corporate audit committees.

The Group takes this opportunity to place on record its sincere thanks to Dr. Y. V. Reddy, Deputy Governor of the Reserve Bank of India for his valuable inputs during the proceedings of the Group's meetings. Our sincere thanks to all members and

special invitees of the Advisory Group and also to the senior officials of the Reserve Bank of India for their contribution and unstinted support in preparing the Report. Our thanks also for the excellent secretarial assistance and co-ordination provided by Smt. Kumudini Hajra, Sarvashri S. Arunachalaramanan, S. K. Yadav, Anamitra Saha, P. N. Kutty, U. D. Kadade and Smt. Prabhu in the preparation of the Report.

PART I : Issues in corporate Governance

Search for Universal Standards

Corporate governance mechanisms differ as between different countries. The governance mechanism in each country is shaped by its political, economic and social history as also by its legal framework. The governance practices adopted in any country reflect national ethos and value systems adopted in that country over a long period of time. For most of the countries the corporate form of organisation did not evolve and emerge through a natural business process. It has been an alien concept transplanted from another soil. Hence different countries have assimilated it in their own way. In view of this, a pertinent question arises as to whether it is possible to have a set of universally accepted corporate governance standards. In the beginning most of the countries found the company to be merely a convenient form of organisation that enabled entrepreneurs to raise money from a large number of investors for funding their growing business or new ventures especially if they are large.

Given the differing social and business value systems of individual countries, assimilation process of the philosophy of the corporate form of organisation was not necessarily similar in different countries. Interestingly, however, in most of the countries, current managements of business entities generally enjoy a special status vis-à-vis the shareholder community. Most of the common shareholders also do not revolt immediately if the existing management tries to perpetuate its control over a business entity so long as the management does not grossly mismanage it. Shareholders start agitating only when they perceive that the company is being highly mismanaged and that the shareholder value is getting destroyed.

Despite the differences in the shareholder philosophies across different countries in regard to corporate governance mechanisms there is no denying of the fact that good governance needs to be encouraged among all the corporate as well as the non-corporate entities. This should hold good in respect of both private and public sector entities. With appropriate variations, the sound principles and practices of corporate governance should also be made applicable to public sector units, banks and financial institutions. The basic objective is to ensure/encourage adoption of good governance mechanisms and practices as they make it possible for more efficient use of economic resources and protection of the interests of shareholders and the society at large. Increasing globalisation is generating highly competitive business climate across all the countries. It is in this context that there is a pressing need to identify best corporate governance standards which facilitate countries like India to prepare themselves to face global competition more effectively. Among the various attempts made to evolve such best global standards, the principles evolved by Organisation for Economic Co-operation and Development (OECD) are considered to serve as a good benchmark.

International Standards & India

While multilateral organisations like the World Bank and the Asian Development Bank have evinced keen interest in the subject of corporate governance the intellectual lead in this area has been given by the OECD in evolving a set of cogent principles of corporate governance. Being an inter-governmental organisation of the industrially developed nations of the world, OECD has come out with a set of clearly defined principles, which it hopes, will be useful to all countries irrespective of their stages of development, legal systems, institutional frameworks, and traditions. The main objective of the OECD in drafting these Principles is to assist both its member governments as also non-member governments to bring about suitable improvements in their legal, institutional and regulatory framework for facilitating good corporate governance regimes. OECD considers that the principles evolved by it contain essential elements that should normally form an integral part of all good corporate governance regimes.

All well governed corporate organisations should recognise the importance of good business ethics and take cognisance of the environmental and social interests of the communities in which they operate. While the OECD principles incorporate codes that are intended to protect interests of the shareholders they are also expected to give due importance to safeguarding interests of the stakeholders like employees, creditors, suppliers, customers, environment, etc. Effective co-operation of all the stakeholders is essential for creating wealth for the shareholders and building financially sound corporations.

The OECD Principles of Corporate Governance released in late 1999 have been accepted as an international benchmark. These standards have been evolved in recognition of growing awareness of the importance of good corporate governance and the demands from the OECD country Ministers in 1998 to develop a set of standards and guidelines. The OECD Principles represent the first major international effort in evolving core elements of good corporate governance regimes. OECD has made it clear that the Principles are not intended to serve as a single model of good corporate governance. Since different countries have different legal systems, institutional frameworks and traditions it may be necessary to adopt these standards in a way that suits any particular country. Therefore, OECD has made these principles non-binding on the member countries. **"The Principles are intended to assist Member and non-member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance."**

While the basic focus of the OECD Principles is on publicly traded companies it is hoped that they will serve, as a useful instrument to improve corporate governance in non-traded companies including state owned enterprises. The logic is that there is considerable synergy "between economic efficiency and corporate governance." If the quality of corporate governance is to be improved in any country the major initiative, no doubt, should preferably come from the corporate sector, both private and public. All the same, the acceptability of well-spelt out corporate governance principles and the willingness of the corporate sector to adopt them would be significantly better if

such principles are well supported by an influential international organisation like the OECD.

At the national level, however, it is equally important that the legal, regulatory and institutional environment should be sufficiently conducive. In the Indian context it means that the Companies Act, the Securities Contracts Regulation Act and the rules formulated thereunder should make it obligatory for the corporate sector to adopt good governance practices. As we would note subsequently there are some areas where suitable strengthening of the policy framework will be necessary. In the area of accounts, adoption of international accounting standards to ensure full disclosure and consolidated accounts would be desirable.

In this context it may be worthwhile to take note of the doubts raised by some about the relevance or applicability of the OECD Principles to all countries irrespective of their cultural and historical background. It is argued that the OECD Principles may not be highly suitable for some of the Asian countries as these are drafted keeping in view the situation of the OECD countries. However, this argument does not seem to be fair in view of the explicit recognition of these factors by the OECD before formulating its governance principles. In the Preamble to the Principles, OECD says, " *There is no single model of good corporate governance. At the same time, work carried out in Member countries and within the OECD has identified some common elements that underlie good corporate governance. The Principles build on these common elements and are formulated to embrace the different models that exist."* This statement is a clear indication of the fact that the OECD principles do not rely on the template of any particular country. They are framed by picking up the best elements of good corporate governance as noted in different countries, which have varied historical and cultural backgrounds, different legal systems, institutional frameworks and traditions. Good governance standards that contribute to creation of higher shareholder value and encourage greater economic efficiency need not therefore be country specific. Adoption of the OECD principles would be in the best interests of all countries which are seriously trying to integrate themselves in the emerging more competitive global economy as most of the member countries give effect to the commitments given by them under the WTO agreements. It is therefore, not appropriate to maintain that the operational framework of the OECD principles has been designed to suit basically the developed free market economies and not countries like India, which is still in the process of integrating with the global economy.

Convergence of Standards

In this context it may be noted that different corporate governance systems are gradually converging in the direction of a broadly unified corporate governance model. Such a governance model is likely to embrace many common elements, which are an integral part of the market oriented governance system of the US and the UK. The process of convergence in corporate governance is gathering momentum due to growing international integration of financial markets, including that in India. As the inflow of direct and portfolio foreign investment increases there will be demands to address the concerns and requirements of foreign investors in regard to corporate governance standards and practices. Among the several key criteria used by the global investors for evaluating investment proposals, good corporate governance generally ranks very high on their value chain. Companies, which are highly transparent and

attach considerable importance to good corporate governance standards, invariably command a high premium in the capital markets because the investment appraisal exercise of such companies becomes more dependable and meaningful.

Companies that intend to raise equity from international markets and list them on global stock exchanges like New York Stock Exchange or NASDAQ would not get better valuation unless they are able to project a good image of themselves. The quality of corporate governance including the disclosure standards adopted by companies seeking capital from global markets becomes crucial for attracting greater investor interest from active global markets. Major institutional investors, in particular, demand that companies should respect good norms of governance and those in management control should respect rights of minority shareholders. Companies should make special attempt to be transparent in regard to the various norms adopted by them in their governance mechanisms. Therefore, due importance is being given by several companies to adoption of higher standards of corporate governance, including appointment of important board committees such as the audit committee, remuneration committee, and appointment/nomination committee.

Globalisation of product markets and deregulation of domestic financial markets are acting as additional pressure points on companies to adopt good governance practices. So long as companies operate mainly in the domestic market, which often restricts competition through regulatory measures and also protects them from foreign competition through trade and tariff barriers there is hardly any pressure on the companies to adopt more efficient production systems or good governance practices. During the last decade economic climate in most of the countries including India is undergoing rapid transformation. Indian economy is increasingly getting deregulated. With growing liberalisation in the entry conditions for foreign direct investment since 1991, product markets are becoming increasingly competitive. As a part of the phased compliance to the WTO requirements Government has been continually bringing down the average level of import duties and removing quantitative restrictions on imported goods. Consequently, competition from foreign producers is becoming more intense as the days pass. To survive in the emerging highly competitive environment, domestic producers will have to adopt production technologies and governance systems and practices that are conducive to efficiency and bringing down unit costs of production.

Firms that operate in highly competitive market conditions of the global market would have to remain much more open and alert to new ideas for improving productivity levels and adopting better corporate governance standards. Good corporate governance is not a pre-condition for developing a strong competitive position in the market and achieve higher productivity and profitability levels. Empirical studies on the subject do not conclusively prove one-to-one relationship between good corporate governance and higher productivity or profitability levels. It may be noted that sound corporate governance may be one of the necessary but not sufficient conditions to realise improved profitability and operational efficiency. Good corporate governance may not be of much help if the strategic direction of the company is wrong, if the management falters in implementing a good strategy, or if the institutional and legal structures of a country hinder rather than encourage efficiency. It should, however, be noted that good governance does help companies to gain respect among customers, suppliers, and investor community. Companies with good governance engender trust

and confidence among all those who have business or investment relationship with them. It is expected that globally competitive forces would induce greater convergence in corporate governance standards across different countries. The more dynamic and forward- looking firms will be the early ones to introduce, on their own, good corporate governance practices that help in improving their acceptability to the foreign investor community. The rate of progress in this area, however, would largely depend on the leadership role played by the government of each country. The governments, which are keen to strengthen competitive advantage of their industries, should hasten the process of reforming their legal, regulatory, and institutional framework so that business entities are encouraged to adopt/imbibe improved corporate governance practices.

National Initiatives

Although the OECD may be the first major inter-governmental body to have taken a significant lead in codifying a set of broad principles of corporate governance, considerable progress was made in the US and the UK in this area largely as a result of the initiatives of the stock exchanges in these countries. The Securities Exchange Commission in the US has also lent considerable support to these efforts. Particular mention may be made about the New York Stock Exchange (NYSE), which strongly supported the setting up of the audit committees of the board. In August 1940, one of its Subcommittee recommended, "Where applicable the selection of the (independent) auditors by a special committee composed of directors who are not officers of the company seem acceptable." In January 1977, the NYSE formally adopted an Audit Committee Policy Statement, which required establishment of audit committees by its listed companies. The London Stock Exchange adopted the recommendations of the Cadbury Committee (1992), which mandated, inter alia, that listed UK companies establish audit committees composed of non-executive directors.

A number of committees set up in the US and UK by the stock exchanges, professional bodies of the accounting practitioners and others have been in favour of strengthening of the effectiveness of the boards of directors of companies. Most of them recommended the setting up various board committees that are strongly represented by the **independent** non-executive directors. The essential qualifications of the independent directors are that, apart from being not involved in the day-to-day operations of the company, they should not have any financial dealings with the company or be involved in any way that may affect their willingness and ability to take unbiased and objective decisions. Some of these committees including that set up by the NYSE have gone at length to clearly spell out qualifications that entitle company directors to be recognised as independent directors. The subcommittees of the board which are strongly represented by the non-executive directors are supposed to keep in check misuse of executive power by, and provide wise counsel to, the full time directors, and also protect the interests of shareholders who have no opportunity or cannot succeed in communicating their views to the board. Recently, NYSE joined hands with NASDAQ and the American Exchange to further strengthen the recommendations on the appointment of the board committees comprising the independent directors, that is, directors who are not involved in the day-to-day operations of the companies. The famous Cadbury Committee set up at the instance of LSE has also made very useful suggestions in further improving the quality of corporate governance of the listed companies.

Different Governance Models

There are broadly three models of corporate governance observed in the developed and the newly industrialising countries. At one end of the spectrum we have the widely discussed "outsider model" of the US and UK. The main feature of this model is the separation of control from ownership arising from widely dispersed equity ownership among large number of institutional and innumerable small shareholders. Consequently, the control of corporate units vests with professional mangers. This is also referred to as the principal-agent model where the shareholders (the agents) entrust the task of running the company to managers (the principals) who are in effective control of the company. Growing importance of the economies of scale and scope has necessitated the birth of large firm with its distant shareholders and professional management. This has given rise to the agency problem viz., how to ensure that the managers function in the interests of the shareholders and the stakeholders.

Both the UK and the US have a long tradition of equity ownership by individuals. During the last five to six decades these countries have witnessed emergence of a large number institutional shareholders like mutual funds, pension funds and insurance companies that have come to hold ever increasing proportion of equity. Since there is a clear separation of control from ownership in these countries the primary objective of their regulatory and legal frameworks is to encourage and facilitate corporate governance systems that protect interests of the widely dispersed shareholders.

In contrast to this outsider model we have two types of "insider models", the European model and the East Asian model. The European continent represents one type of insider model, although there are several versions of it in different European countries as also in different sectors of a given country. The main feature of the European insider model is that a small relatively compact group of shareholders (who maintain relatively longer term and stable relationship among themselves) are able to exercise control over corporate entities. The countries in which such an insider model is common are the ones that have witnessed less institutionalisation of equity holdings than the Anglo-American outsider model. These countries also reflect much higher dependence of the corporate sector on banks as a source of finance. Generally, the corporate entities also have much higher levels of debt-equity ratios.

The typical East Asian form of corporate governance model embodies a purer version of the insider model where "the founding family" generally holds majority of the controlling shares, directly or through other holding companies, most of which in turn may be controlled by the founding families. The main difference between the European and the pure East Asian version is that, in the East Asian case, close knit families are generally the controlling entities. The East Asian insider model is therefore far simpler version of the European insider model. The European insider model, on the other hand, is characterised by a variety of controlling forms including one interesting form where the controlling shareholders are backed by complex shareholder agreements. Countries with predominantly insider form of organisations are more tolerant of their activities even when such activities are not fully in the interests of the common shareholders.

Corporate Governance in India

The predominant form of corporate governance in India is much closer to the East Asian insider model of corporate governance. There are also a number of corporate entities that resemble the European version where the control is maintained through pyramidal form of ownership and control. The number of corporate entities, which reflect the pure outsider model, is relatively small in India. A distinguishing feature of the Indian Diaspora is the implicit acceptance that companies belong to the "founding families" though they are not necessarily considered to be their private properties. The concept of ***industrial house*** popularised sometime ago by the Dutt Committee and the MRTP Act is still a commonly accepted reference point in most of the discussions on patterns of ownership of industrial/business units in India even today.

Institutionalisation of shareholdings in India really began in a perceptible way after the setting up of the Unit Trust of India (UTI). Since then, the mutual fund industry has grown in a big way. By now a large number of mutual funds managed by the private and public sector fund managers as also by the foreign institutional fund managers are actively operating in the country. The aggregate assets under their management are in excess of Rs 100,000 crore. Although the DFIs also do hold equities in their portfolio they are not large holders like the mutual funds for the simple reason that the DFIs are marginal players in the secondary market and their investment operations are incidental to their main business of lending and related activities. Until recently, the operations of the DFIs were confined to selling the shares acquired by then through underwriting operations and also to some extent through the exercise of their conversion option stipulated in the loan agreements. In the case of mutual funds, their total holdings of equities account for about two-thirds of their aggregate portfolio, with the balance being accounted for by the debt instruments. Even in respect of companies where the institutions are relatively large shareholders, they have been rather passive observers in the area of corporate governance. There are a number of large corporate units in India in which the combined shareholding of the institutions may be in excess of the holdings of the "promoter group" who are in control of the management. Even in such cases the institutions do not exercise their rights as shareholders.

Good Governance Mechanism

Corporate governance can be defined as the system by which business entities are monitored, managed, and controlled. At one end of the spectrum are the shareholders as owners of the business entity since they provide the ultimate risk capital. At the other end are the 'managers' or the executive directors of the company who are in control of its day-to-day affairs. As the elected representatives of the shareholders it is the responsibility of the entire board of directors to direct operations of the company. As the owners of business the shareholders are expected to monitor and evaluate operations of the company as well as the performance of the entire board of directors and in particular the effectiveness of the full time or executive directors**.** A good structure of corporate governance is one that encourages symbiotic relationship among shareholders, executive directors and the board of directors so that the company is managed efficiently and the rewards are equitably shared among shareholders and stakeholders.

In the discussion that follows the legal and regulatory framework of corporate governance, as it exists in India today, is compared with that recommended by the

OECD principles. This discussion is also supplemented by a comparison with recommendations of the committees appointed by NYSE and LSE. The discussion on the situation obtaining in India is analysed with reference to the all the corporate sector entities belonging to industry, trade, services, banking and finance, irrespective of the government or non-government nature of ownership. *Hence the recommendations made by the Group are applicable to all the corporate entities irrespective of the type of economic activity and nature of ownership.*

The Group, however, found it necessary to give special attention to the issues connected with the governance of the Public Sector Units (PSUs) and the Public Sector Banks (PSBs) and DFIs, which have been set up as companies although some of them may be coming under the purview of special Acts of the Parliament. The rights of the shareholders of PSUs and PSBs stand considerably abridged. In regard to the PSUs it has been noted that the autonomy of their boards has got almost completely eroded due to special legislative provisions or notifications, day to day interference with their functioning, and issuance of detailed instructions covering every area of their operations by the concerned administrative ministries. Similarly, in regard to all the banks and in particular the PSBs their boards no longer appear to enjoy the necessary degree of autonomy and independence due to the directives/guidelines issued by RBI and the government. The regulatory framework for the Non-Banking Finance Companies (NBFCs) is gradually evolving and becoming more effective. It would be desirable to bring the NBFCs also under an effective corporate governance regime, which is somewhat similar to the one that is appropriate for the banks and institutions.

As is generally the case in most of the countries including India, a detailed statutory framework of corporate governance has been defined primarily by the Companies Act. Most of the important requirements set out by the OECD principles in regard to good corporate governance are reasonably well defined in the Companies Act in India. These provisions have been further supplemented by SEBI recently. Based on the recommendations of an expert committee on corporate governance SEBI has directed all the stock exchanges to amend their Listing Agreement to incorporate new clauses to make it binding on the listed companies to improve their governance practices. SEBI has, not mandated these requirements to all the listed companies from day one. These new measures are being implemented in a phased manner and the first phase covers the large listed companies included in the main equity index viz., S&P CNX Nifty of the National Stock Exchange and companies included in the A Group of the Bombay Stock Exchange. It is proposed that most of the listed companies on all the stock exchanges will be brought under the purview of these measures in the immediate future.

It may be noted in this context that, the main instrumentality through which SEBI seeks to ensure implementation of its corporate governance measures is the listing agreement signed by the companies with the stock exchanges. Consequently, a vast majority of the companies that are not listed on any of the stock exchanges will remain outside the purview of SEBI's guidelines. Secondly, the listing agreement is a relatively weak instrument as compared to the Companies Act as its penal provisions in the event of non-compliance are not hurting enough. The maximum penalty a stock exchange can impose on any company that does not abide by the provisions of the listing agreement is suspension of trading in its shares. The stock exchanges do not

even have the powers of de-listing the company. The penalty that the stock exchanges can inflict hurts the investor community much more than the management of the company, which violates the provisions of the listing agreement.

Under the current arrangements companies which are making public issue are mandated to list on the regional stock exchanges. A regional stock exchange is defined as the exchange that is nearest to the registered office of the company. Since significantly higher trading is taking place on NSE and BSE than on most of the regional exchanges even in respect of several companies listed on the smaller regional exchanges the clout of the small regional exchanges vis-à-vis the listed companies is diminishing. In respect of some of the regional exchanges there is hardly any trade in respect of the companies for which they are recognised to be the regional exchanges. Secondly, on account of the weak financial position of most of the regional exchanges they do not have the organisational resources to monitor and ensure that their listed companies abide by all the listing requirements and in particular the new corporate governance standards.

It is recommended that the penal provisions of the listing agreement should be strengthened and the management of an erring company is held responsible for all major violations in regard to the corporate governance norms as stipulated in the listing agreement. In order to increase the effectiveness of the listing agreement it would be desirable that the functions connected with the listing of companies, together with enforcement of penal provisions for any major violations of the listing guidelines, are entrusted to a designated central authority. The Group is of the opinion that this issue clearly falls within the purview of SEBI.

A more effective solution would be to incorporate all the requirements in regard to good corporate governance in the Companies Act. It is also necessary to have effective penal provisions in the Companies Act so that the management of a company that does not have any incentive to violate the required corporate governance norms.

PART II : The OECD Principles

The OECD corporate governance principles cover five major areas: (1) The rights of shareholders; (2) The equitable treatment of shareholders; (3) The role of stakeholders; (4) Disclosure and transparency; and (5) The responsibilities of the board. For the sake convenience the following discussion will adopt the same sequence for comparing the situation as it obtains in India vis-à-vis the corporate governance standards as laid down by the OECD. At relevant places the best standards recommended by and adopted at the instance of the committees of the stock exchanges in UK and the US will also be covered. The special issues and problems relating to corporate governance in the PSUs, PSBs, the DFIs and other banking institutions are discussed separately.

1. *Rights of Shareholders*

The basic shareholders' rights mentioned by the OECD principles, like getting registered the right to ownership with the company, conveyance or transfer of shares, obtain relevant information from the company on a timely and regular basis, participate and vote in general shareholders' meetings, elect members of the board, and share in the profits of the company are all reasonably well protected by the

Companies Act in India. Law also protects the rights of shareholders to have a say in the amendments to memorandum and articles of association, reduction or augmentation of share capital and extraordinary transactions that result in sale of a major part or the whole company. Whenever companies want to hold general body meetings of the shareholders, the notice to that effect has to be given to the shareholders at least 21 days in advance. Shareholders have to be informed about the date, time, location, and agenda of such meetings. It is mandatory to provide to provide to shareholders explanatory details about the items covered in the agenda along with the notice for the meeting. Shareholders are given an opportunity to ask any relevant questions at these meetings. Shareholder/s with 10% of the voting rights have the right to get items of their choice to be in the agenda of such meeting for discussion. Shareholders can vote in person or in absentia and both voting rights are treated equally.

OECD principles emphasise that "structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed." In India, as of today, companies are not required to make any such disclosures about the aggregate holdings of the promoters and their group companies. Companies are required to file details of their shareholding to the registrar of companies. Listed companies are required to file a return with the stock exchanges where they are listed. The disclosed information is such that it is difficult to make out as to what is the actual or effective level of shareholding of the promoters who are in the management control of the company. Several promoter groups exercise their control through a pyramid of subsidiary and holding companies. Trusts are often the route with promoter controlled trusts holding shares in companies. Some industrial houses also favour the route of interlocking of shareholdings among the companies under their control.

From the returns filed by the companies one may find that apparently there are large number of companies in which the promoters' holdings are significantly below the 51% mark and yet they are in full control of their companies. It is surmised that several promoter groups exercise management control through the shareholdings of the Trusts or associate companies. Moreover, institutional investors in India, some of which have large chunk of the shareholdings, are generally not much inclined to disturb management control of companies even when the promoter groups may be performing poorly. Whatever be the situation in this regard, it should be made mandatory on the part of the promoters to fully disclose their total direct holdings and indirect holdings (that is holdings through the associate and subsidiary companies, trusts under control, shareholder agreements, etc.) in companies at any point of time as also whenever there is any noticeable changes in such holdings. The promoters should be asked to disclose any changes in their controlling stake whenever the change represents increase or decrease in holdings by one per cent or more so that rest of the shareholders are kept informed about the promoter dealings in own company shares. Such information is of vital importance for the common shareholders, as they should know how the management control is being exercised or whether insider trading is going on.

(a) ***Market for Take-overs***

In the absence of correct information on the arrangements of the promoters for management control 'the markets for corporate control' do not " function in an

efficient and transparent manner" in India. Currently, considerable debate has been going on in this area after some corporate raiders became active. One of the important points being debated is, whether the promoter groups should also be allowed to have level playing field with the raiders by stepping up the creeping acquisition limit to 15%.

Much of this debate becomes opaque in the absence of any meaningful information on promoter shareholding in respect of the companies listed on the stock exchanges. If the promoters under attack resort to other ways of strengthening their shareholdings it is very difficult to know whether they are abiding by the existing guidelines. It is highly essential that the exact shareholdings of the promoter groups and structure of their control are disclosed fully and fairly at regular time intervals both for facilitating regulatory surveillance and adding to common shareholders' comfort. Shareholders have a right to know about all the dealings of the promoters in the shares of the company in as much as they know the holdings of others as soon as they acquire more than 5% shareholdings.

The current social ethos in India favours the entrenched management status quo, irrespective the quality of the management. In that sense, it is fair to postulate that the true spirit of corporate democracy has not yet been properly understood in our society. Part of the difficulty is that common shareholders generally suspect all talk of social interests by the corporate raiders. Some shareholders wonder whether corporate raiders themselves may have selfish motives in dislodging or destabilising existing management. That is why the entrenched management comes to be seen, in such situations, to be the social underdog by the community at large. Consequently entrenched managements continue to have lease of life.

In India, the market for take-overs has become active during the last couple of years. Deregulation and competition have encouraged trends in favour of mergers, acquisitions and restructuring. Majority of the acquisitions has been of the friendly type. As expected, hostile take-overs have been generating considerable heat and debate. SEBI has worked out a take-over code, which is currently in the process of getting revised. Thus, there have been positive developments in the direction of facilitating take-overs provided they are as per the clearly spelt out or well defined code.

(b) ***Role of Institutional Investors***

The OECD principles state that " institutional investors, should consider the costs and benefits of exercising their voting rights." While the OECD principles do not make any recommendations as to whether the institutions should or should not exercise their voting rights, they do suggest that the costs and benefits of such an action should be carefully evaluated. The costs of not exercising voting rights even when the company is being clearly mismanaged and shareholder value is being destroyed by the existing management is obvious. Cadbury Committee has clearly come out with a recommendation that institutions should take active interest in corporate governance as they have special role and responsibility in safeguarding public interests. As institutions have much better access to information and better monitoring capabilities the Cadbury Committee is of the view that institutions should be encouraged to make greater use of their voting rights. They should take particular interest in boards where there is concentration of power in the hands of the current management so as to

promote the influence of independent non-executive directors. Since institutional investors like mutual funds are the true trustees of the money investors have given to them to manage more efficiently, they have a special role to play in the Indian context where majority of the Indian companies conform to the "insider model" and the promoter family interests receive much higher priority over the general shareholder interests. Until best standards of corporate governance percolate deeply across major part of the corporate sector it would be highly inappropriate to argue that institutional shareholders should not have even the normal shareholders' rights. However, the institutional investors need to be alert and should exercise their power to get good independent directors elected on the boards of companies that do not respect good governance standards.

In respect of companies in which there is very high concentration of shareholding with the promoter group it is necessary to ensure that the boards are adequately represented with independent directors who are alert and effective and the board committees are active in ensuring good corporate governance. Recently, SEBI has permitted large companies to come out with only 10% initial public offerings. In respect of such companies it is necessary to devise mechanisms to ensure that the interests of non-promoter shareholders are well protected. Institutions have an important role to play in all cases where the public shareholdings are relatively small. In this context, it is worth noting that the US regulators insist on disclosure of concentrated holdings of promoters as a risk factor from common shareholders' viewpoint. Even if institutional shareholders are not keen to have their nominees/representatives on the boards of companies they should use their good offices to ensure that companies appoint sufficient number of independent directors who have no financial dealings with the companies.

One of the effective mechanisms to improve external monitoring would be to strengthen the monitoring and supervision by the creditor institutions like banks and financial institutions. As far as possible, lending institutions should not have their nominees on the boards of borrowing companies to avoid conflict of interests. However, they should monitor governance in the borrowing companies as part of best lending practices. The recent Asian crisis has highlighted the need for effective monitoring by the lending institutions. Since banks and FIs often rely on relationship-based financing system they are often slack in monitoring performance of their borrowers and utilisation of funds. Bank supervision and regulation done by RBI needs to be strengthened in such a way that banks and FIs are goaded to effectively perform their role as external monitoring and control agents of their corporate borrowers. The Group is of the opinion that promotion of good governance practices and effective credit monitoring mechanisms among the creditor institutions is one of the important responsibilities of the RBI.

2. Equitable Treatment of Shareholders

Under the Indian Companies Act all shareholders are treated equitably and the law does not make any distinction among different shareholders holding a given class or type of shares. In other words, all equity shareholders have the same rights and their voting power is directly proportional to their shareholding. Similarly, all preference shareholders are entitled to equitable treatment before law irrespective of the size of their shareholdings. Any changes in voting rights of common shareholders can be done only with the consent of those shareholders. Thus, in regard to bestowing equal

rights to shareholders under any class, the Indian law offers full comforts recommended by the OECD principles. However, the rights of shareholders' of banks and the public sector undertakings are seriously abridged.

In India, shareholders with any grievance can seek remedy in the court of law. Shareholders are free to seek enforcement of their rights by filing suits in the courts against the management of the company including the board of directors of the company. While in spirit the law does provide the necessary comfort to the shareholders, in reality the shareholders are not well protected because of the protracted delays of the judicial process. While the management of the company can fight on the case indefinitely irrespective of the costs (both in terms of time and money) the common shareholders normally cannot afford the costs of grievance ridressal through litigation.

During the recent past several companies have 'vanished in thin air' after raising capital from the public. The subscribers to capital of such companies have lost hundreds of crores of rupees. Most of the investors who have lost their money do not consider it worthwhile to seek legal remedy to enforce their rights in recovering money, although they have been openly defrauded. The authorities have also not been able to take effective action against such promoters. From the recent experience it appears that not much can be done to offer solace to investors who have lost money in the vanished companies. But their other grievances with several existing "traceable" companies can be resolved if the investors can be given access to arbitration mechanism. A much shorter and economical method to partially resolve investor complaints vis-à-vis the companies is to bring all such disputes under the recently amended Arbitration Act, which has been found to be quick in resolving primarily investor disputes. Although enforcement of the awards may not be very quick at, least the promoters can be legally declared as defaulters so that they would be prevented from further mischief openly.

(a) ***Voting by the Custodians***

Unlike in some of the European countries the custodians cannot vote unless they are specifically authorised by the shareholders to do so. Normally the voting rights continue to vest with the shareholders themselves even in respect of the depository shares. If the custodians are asked to attend shareholder meetings with proxies they have to vote as per the instructions of the shareholders. Indian law fully protects the shareholders from any misuse of power by the custodians.

(b) ***Hassles in Voting***

Equitable treatment of shareholders should mean that they do not face undue difficulties to exercise their voting rights. Real life situation in India is highly discouraging from the viewpoint of the common shareholders. Those in control of management often make it inconvenient for the common shareholders to attend shareholders' meetings. As per the law general shareholder meetings have to be held at places where their registered offices are located. Even some of the well-known companies select extremely inconvenient places for locating their registered offices so that the shareholder meeting can be safely held without the bother of facing inconvenient questions/voting of the aggrieved shareholders.

The difficulty faced by the shareholders can be resolved to some extent by changing the rules of the game. Through suitable legislative amendments it should be made mandatory for any company to hold its shareholder meetings at the town/city where the chief executive of the company is normally located/headquartered. The company should hold one or two meetings a year by rotation at different places where very large number of shareholders reside so that common shareholders have opportunities to interact with board and management of the company periodically. Secondly, least cost modern technology such as Internet, with appropriate safeguards, should be deployed for the purpose of ascertaining shareholder on different issues or facilitating shareholders to cast their votes. A recent amendment to the Companies Act makes it mandatory to ascertain voters' preferences in certain matters only though the postal-ballot system instead of transacting the business in general meeting of shareholders. The Central government is yet to notify the types of business to be conducted by the companies only through the postal ballot system. For this purpose the company has to send the resolution/s by registered post or any other method to be prescribed by the government with a prepaid envelop to facilitate receipt of assent/dissent of shareholders within a prescribed period. This provision also includes exercise of voting rights through electronic mode.

(c) ***Insider trading***

Persons close to the company have access to price sensitive information, which is generally made available to the shareholders with a time lag. Such persons close to the company are called as insiders and there are possibilities that the insiders may misuse price sensitive information and indulge in trading in the market for personal benefit. Until recently, before SEBI came out with insider trading regulations, insider trading was not considered illegal. SEBI is in the process of reviewing these guidelines to make them more effective. All over the world it has been noted that insider regulations are very difficult to enforce since the number of "insiders" runs into very large numbers. It is difficult to continually probe insider cases as they are time consuming and tedious for the investigators. It is only when insider trading is suspected to have taken place on a massive scale that investigations are generally launched. Given the limitations involved in tracking and effectively proving insider trading offences in the courts of law, it would be preferable to minimise the scope for such cases through more frequent, timely and exhaustive disclosures of all the price sensitive information to the shareholders. Given the cost-benefit of the insider regulation and its enforcement difficulties, much greater emphasis should be laid on improving the quality of disclosures rather than trying to plug the loopholes through too detailed rules and regulations.

(d) ***Disclosures by Directors***

Board of directors should avoid conflicts of interests when they take decisions on the matters brought before them. Under the Indian law each member of the board is required to make full disclosures to the board about his pecuniary interests in other companies or firms as also the names of the near relatives. This helps in tracking directors' interests when they participate in the decision making process. If the company is having any financial dealing with another entity in which any of the director is *'interested'* such a director has to abstain from participating in the discussion and decision making process. To strengthen the effectiveness of this provision it would be desirable that the statements of directors' interests are disclosed to all the shareholders through the balance sheet.

3. The Role of Stakeholders
Although the shareholders are the true owners of the company, its functioning affects several other economic players in the society. Employees of the company are the first to be affected directly by what happens to the company. There is significant synergetic relationship between the company and its employees. Unless the company functions as a viable and profitable entity employees will not be able to get rewarded well. Similarly, unless the employees offer fruitful co-operation to the company its functioning will get adversely affected. Corporate entities have also impact on the environment of the community in which they are located. Polluting units may make profits for the shareholders but they would not be adding real value to the society unless they are obliged to take effective anti-pollution steps.

The OECD principles therefore emphasise that the rights of the stakeholders as established by law should be recognised and "*active co-operation between corporations and stakeholders in creating wealth, jobs, and sustainability of financially sound enterprises"* should be encouraged. The crucially important operative part of these guidelines relating to the stakeholders is that corporations and the stakeholders should actively co-operate to create wealth and jobs in such a way the corporation should remain viable and sound. Some of the provisions of the Indian laws in regard to legal rights of the stakeholders are not always conducive to the sustainability of the corporation. Labour laws in particular have often not encouraged responsible behaviour on the part of the unionised labour. With changing production technologies in different industries and the onset of intense global competition, certain reorganisations in production systems become periodically inevitable. But sometimes, due to an absence of co-operation from the unionised labour a number of units have become/are becoming unviable and the shareholders and the stakeholders including labour themselves ultimately turn out to be the big losers. It is mainly for this reason that the German corporate governance model of two-tier board with large representation of labour on the supervisory board does not appear to be particularly attractive in the Indian conditions.

4. Disclosures & Transparency
Companies should make maximum possible timely disclosures on all important matters relating to their financial situation including the balance sheet and profit loss accounts, ownership patterns and shareholdings of the promoters and other large shareholders. Such detailed information helps in infusing a sense of discipline and accountability among those who are in the management control of a company. Increased transparency and information help to reduce the so-called information asymmetry between management and shareholders, including the local and foreign investors. Local lender or an investor is likely to support an entity more willingly when he is satisfied that the entity has given him the true picture and that there would be no (unpleasant) surprises. In the context of globalisation where direct and portfolio investments and cross-border debt flows are playing an increasingly significant role, convergence of corporate governance standards is especially important. Adoption of internationally accepted best disclosure standards by an entity improves the understanding and comfort of foreign investors about the operations of companies and helps to lower their risk perceptions. This prompts them to provide capital at lower cost or pay higher premium for equity. The net result will thus be to lower cost of capital to such entities.

By and large, disclosure standards in India are reasonably satisfactory. But they need to be improved further so as to bring them on par with some of the best international standards. The Companies Act stipulates the format in which annual accounts are to be presented. SEBI has mandated large listed companies to disclose summary results on a quarterly basis while for other companies on half-yearly basis. Eventually, all these results should be disclosed based on audited accounts so as to give more reliable information to the shareholders about the performance of their company. Although most of the companies present their annual accounts covering twelve month period, some companies take advantage of the current legal provisions and choose to present accounts for periods varying from 6 months to 18 months. They choose this option, only once in a while, primarily as a tax saving measure. All the same, from the viewpoint of better and full disclosures, companies should be mandated to circulate among the shareholders the annual accounts on a twelve monthly basis also during the years when they decide to change their accounting year for tax purposes. From the viewpoint of full and meaningful disclosures, shareholders should be given an opportunity to have accounts on a comparable basis and for a comparable period. In other words the gap between two balance sheets given to the shareholders should not be more than 12 months.

There are a number of specific areas where the quality of information provided by the companies in India needs to be further improved. Whenever promoters have a number of companies under their management control, they have an opportunity, if they like to do so, to mislead the shareholders about the financial state of any given company through inter-group company transactions and transfer pricing. In the US this problem has been effectively dealt with by making it obligatory for companies to present consolidated accounts of all the affiliated or group companies. The US regulations also require presentation of accounts division-wise whenever activities of some of the divisions are quite sizeable. Interestingly, some of the Indian companies that have tapped the US market for capital do make exhaustive disclosures as required by the US regulatory authorities. But the same companies do not make similar disclosures to the Indian shareholders. The rules of the game should be changed and all the companies should be asked make detailed disclosures irrespective of whether they tap the US markets or not. In December 2000 ICAI circulated an exposure draft on "Consolidated Financial Statements" and it is expected that the ICAI will soon issue the final version of this for implementation. ICAI has already issued guidelines regarding presentation of division-wise accounts.

In a corporate democracy it becomes possible for the shareholders to monitor performance of their companies fruitfully only if they have access to meaningful, reliable, and comparable information in sufficient detail and at more frequent intervals of time. Unless the shareholders are in a position to get required information for effectively monitoring performance of their companies they will not be able to exercise their voting rights meaningfully. If shareholders get disenchanted with the capital market because of the opaque quality of the financial information, markets will not be able to attract risk capital for funding new or expansion projects.

A strong disclosure regime that forces companies to make sufficiently meaningful and detailed disclosures at frequent time intervals, would act as good disciplining mechanism on the managements. Companies that follow transparent disclosure policy

generally enjoy better valuations and command a higher premium in the market. Such companies would be able to raise fresh capital from the market at a relatively much lower cost. From an overall social perspective strong disclosure regimes create a public good. Market analysts would be able to assist investor community better and help them to take right investment decisions. The task of the policy makers also gets easier to the extent that they are able to get more reliable information that can be used to analyse trends more accurately and take appropriate policy decisions in time.

For disclosure regimes to succeed and become acceptable to the economic agents, the cost- benefits of the disclosure requirements should be weighed carefully. As a broad thumb rule, the items on which information is required to be disclosed by the companies should be material in nature. In other words, if the absence of particular type of information is likely to lead to less efficient decision making process such information should be made available to the shareholders. Secondly, the costs of compiling and disclosing such information should not place unreasonable administrative burden or financial costs on the company. To minimise the costs of disclosures and to make them less cumbersome, electronic filing of information should be encouraged. Such information can be easily hosted on a web site so as to minimise costs of storage of information and its quick retrieval.

Companies should provide at least the following information to their shareholders:

Financial health

Along with the detailed financial results, companies should provide cash flow statements and detailed explanatory statements in respect of the accounts. Companies should be asked to give full explanation about large transactions under some of the sub-head items given in the schedules to the annual accounts. The report of the directors should discuss meaningfully the financial statements as the shareholders are not merely interested in the statements of accounts as required under law but also in "the information that may shed light on the future performance of the enterprise." Most of the Indian companies do not give details about the off-balance sheet items such as guarantees or similar commitments given to the related or group companies. It is desirable that such information should be made available to shareholders so that they are able to estimate financial risks/exposures of their company.

Company objectives

Companies should share fully details about all their commercial activities as also "disclose policies relating to business ethics, the environment, and other public policy commitments."

Major share ownership & voting rights

As already noted above the information furnished by the companies to the registrar of companies and the stock exchanges where they are listed is not meaningful enough. It is difficult to make out the voting rights controlled by the promoters of a company through shareholder agreements/understandings, associate companies, trusts under their direct or indirect control. The shareholders should have the right to know about interlocking shareholdings (cross shareholdings and pyramiding), underlying ownership of shares held by nominees and holding companies and the changes in ownership with as minimum time lags as possible. It has been recognised that

excessive concentration of shareholdings with the management/controlling group is a risk factor from the common shareholders' viewpoint.

The details about shareholdings have become very important especially after the take-over activities have increased recently in India. Once it is made obligatory for the promoters to disclose such information at one point of time as also periodically, the changes in controlling holdings will become known to all including the regulatory authorities. Companies should also disclose individual names of shareholders once their holdings are one per cent or more of the company's voting stock. Such information should be hosted on the web site and updated at regular time intervals not exceeding three months. After such information becomes a public knowledge there will be much greater transparency in respect of take over attempts made by raiders or the promoters to increase/decrease their shareholdings. As soon as the non-promoter holdings reach 5% limit such holders should be mandated to disclose their intentions immediately on the web site itself. Information on related party holdings should also be disclosed. Such information is very useful for the common shareholders to protect their commercial interests.

Risk Factors

Shareholders, lenders, and all those having financial dealings with company would like to be aware of the material risks faced by the company. The risks faced by a company may be specific to the industry to which the company belongs or geographical area where the company is located or that the company may be heavily dependent on one or two raw materials, the supply of which may be erratic. Companies face financial risks when they borrow heavily at variable interest rates or when they borrow in foreign currency. Exchange rate may also impinge on profitability when raw materials are imported and the markets for the final products are in the home country. During the recent, past some companies have faced serious problems when they did not hedge their foreign exchange risks or took speculative positions in the derivative markets not directly related to the business of the company. It should be made obligatory for companies to disclose all these risks including off-balance sheet items to the extent they are likely to erode their financial health when unfavourable turn of events takes place. For the benefit of the shareholders and the creditors it should be mandatory for companies to disclose whenever they default or are likely to default in their debt servicing obligations.

Quality of Financial Reporting

The accounting and auditing standards adopted by a company often depend on the quality of corporate governance adopted by it. Some companies that excel in corporate governance standards provide a lot more information even though it may not be mandated by the law. Measures to improve independence of external auditors and their accountability to the shareholders need to be ensured. Some of the measures like constitution of the audit committee of independent solely of directors do increase the independence and effectiveness of the auditors, both internal and external. An important mechanism to enhance independence of the auditors is to ensure that they are remunerated properly and that they do not receive too many other assignments from the companies they audit so that their ability to act independently is not compromised. Annual reports should disclose all the payments received by the auditors over and above the audit fees since such information may help in shedding light on the level of independence of the auditors.

5. Responsibilities of the Board

Corporate governance structures adopted in different countries are basically products of their economic, political, and social history. A limited liability company in any country is essentially a creature of the statute of that country. Since it facilitates mobilisation of sizeable amount of capital from a large number of investors, the company structure leads to concentration of economic power in the hands of a few people that constitute the board of directors. The statute, therefore, should not encourage or facilitate continuation of self-perpetuating oligarchies or despotic regimes, which have a tendency to get entrenched over time. If it has been found that because of the existing deficiencies in the statues such oligarchies or dictatorships have tendency to proliferate, necessary changes in the relevant statutes should be made. All the same it needs to be recognised that a sharp and sudden break from the history in terms drastic changes in the statutes may sometimes prove to be counterproductive. Reforms in corporate governance structures that have evolved over a long period of time should be brought about in such a way that the intended results are achieved without generating excessive and destabilising frictions.

There are basically two models of board structures, the two-tier board and the unitary board. The most discussed two-tier board is one that is commonly adopted in Germany, Austria, and the Netherlands. All members of supervisory board are non-executives. In Germany the supervisory boards of some large companies are somewhat akin to partnerships between labour and capital. In such supervisory boards there is an equal representation to nominees of employees' trade unions and representatives of shareholders often appointed by banks. It has therefore been observed that members of the supervisory boards are seldom truly independent. In this structure the supervisory board is relatively more important as the de jure power to appoint members of the executive board vests with it. The trade union representatives on the supervisory board rarely have the power to block the appointments on the executive board. Proposals pertaining to the affairs of the company are put up to the supervisory board by the executive board, which it can only either approve or disapprove.

Close observers of the German system have noted that in reality Germany does not have a truly perfect two-tier board. In Germany, the chairman of the supervisory board is expected to play a crucial role in ensuring that there is a harmonious relationship between the two tiers of the board. There is a fine balance of relationship as also sharing of power and responsibility between the two tiers of the boards of most of the best-run German companies. Unitary boards of some of the best managed companies in the US and the UK also contain most of the very good features of the two-tier boards in Germany viz., encouraging entrepreneurial talents of the executive directors together with effective monitoring and guidance from the non-executive directors. Most of the countries in the world including India have adopted the unitary board system. Therefore, the debate really is not about the merits or demerits of the two-tier board versus and unitary boards but how to enhance effectiveness of unitary boards.

For unitary boards to function efficiently they should have a strong representation of non-executive directors who are capable of taking independent stand and are not cowed down by the full-time directors on the board. The main task of an effective

board is to monitor performance of the executives and also to ensure that returns to the shareholders are maximised while not making any compromises with the provisions of law and interests of the society as a whole. If the board is capable of performing these functions without being unduly influenced by the full time executives who are also members of the board, such a board does incorporate the best element of a two-tier board. True independence of the board can be ensured by having a majority of outside directors who do not have any financial or pecuniary involvement with the company and are not in any way related to the promoters or the senior executives including the full time directors of the company.

While India has adopted a unitary board structure a vast majority of the companies are not having truly independent boards. Most of the companies in India belong to the "insider" model where the promoter families have a tight control over the functioning of the boards. The non-promoter members of the board often are hand picked by the promoters themselves either on account of their business dealings with them, or that they have invited them either for bestowing prestige value to their boards or on account of mutual understanding to be on each other's boards. Board meetings are often not taken seriously and are held only once in a quarter, that too because of the statutory requirements. Since the board is not provided with vital and required information for the purposes of discussion and decision making the board is not in a position to monitor, review, and guide the activities of the company meaningfully.

Restructuring of Board

One of the most important reforms in the area of corporate governance in India should be in regard to restructuring of the boards of directors. Since this is the most crucial part of the reform it should be brought about through suitable amendments to the Companies Act. It should be made mandatory that majority of the board members are really independent directors who are not obliged either to the executive directors or the promoters of the company. To ensure reasonably good discussion at the board meetings all companies with net-worth of Rs. 15 crore or more should have minimum board strength of 10, of which at least 5 directors should be truly independent. The concept of independent directors being relatively new to the country it needs to be defined as clearly and unambiguously as possible. A director, to be considered as an independent director, should not have any of the following qualifications:

- A director being employed by the company or any of its affiliate/associate company during the current year or any of the past five years;
- A director accepting any compensation from the company or any of its affiliate/associate other than compensation by way of sitting fees or any other form of compensation paid to all the other non-executive directors;
- A director being a member of the immediate family of an individual who is part of the promoter group or has been, in any of the past five years, employed by the company or any of its affiliate/associate company as an executive officer;
- A director being a partner in, or a controlling shareholder, or an executive officer of any company/business entity with which the company has significant business relationship during the current year or during the last five years;
- A director being employed as an executive of any other company, where one of the corporation's executives serves that company's board.
- In the case of public sector units or public sector banks, officers appointed by RBI/GOI as nominees should not be considered as independent directors.
- All nominees appointed by the regulators

Unless there is a clear and unambiguous definition as to who really is an independent director, the term independent directors is likely to be deliberately misinterpreted. Several companies may be tempted to make an untenable claim that their company is in conformity of the requirement of having the required number of independent directors. The unitary board structure, which the Company Act in India has adopted, will not ensure good corporate governance unless the company boards have adequate number of truly independent directors. The independent directors should be playing the role of moderators vis-à-vis the management and protect the interests of common shareholders and the contractual and statutory obligations to the stakeholders. The role of the independent directors is somewhat akin to that of the supervisory board in Germany. The independent directors will be in a position to play their role more effectively especially if they also possess special expertise in any one of the areas connected with the operations of the company on the boards of which they are appointed. In some ways, the independent directors may be deemed to be the trustees for protecting the interests of the common shareholders and the stakeholders. They are expected to protect interests of all those who are affected by the operations of the company, in one way or the other, but do not have any opportunity to communicate their views to the board.

Modern company organisations have become fairly complex and need close supervision and effective directions from well constituted boards. Given the nature of the task, the full board may not be able to meet more frequently to devote its close attention to the business of the company. It is therefore essential to get some of the board functions performed through specially constituted board committees, which are represented mainly or wholly by the independent directors. These board committees should be assigned some specific areas for their monitoring and direction. Among these tasks, the audit function is perhaps the most important one. Three other board committees that have useful role to play are the remuneration committee, the appointment committee and the investment committee (for treasury operations). The investment committee is basically required for companies that have to deploy and manage sizeable financial resources profitably, keeping in view the risk-reward trade off different investment options. Also companies, which are implementing expansion/diversification projects should appoint project implementation committees that can perform a useful role in monitoring implementation of such projects effectively.

Several large companies float subsidiary companies as a conscious business strategy. The management of these subsidiary companies and their relationship with the parent companies should be governed by the same principles of good governance. Requirements of good corporate governance such as independent directors, board committees, which apply to the parent company, should also be made applicable to the subsidiary company. Further, wherever a subsidiary company uses the name, logo, etc. of the parent company, which has the effect of "Holding-out", the parent company should give a firm undertaking to support its subsidiary. This has a particular significance in respect of financial sector companies and their subsidiaries.

Audit Committee

For an audit committee to be really effective and serve useful purpose it should be composed of at least three members of the board, who are all independent directors. It

should be made mandatory that at least majority of its members including its chairman are truly independent. If it is felt that one of the non-independent directors is to be included in the audit committee it should be for a justifiable reason such as good grounding in any particular area of great relevance to the area of business of the company. The reasons for having non-independent directors in the embers of the audit committee should be disclosed in the annual report of the company. The members of the audit committee should be financially literate. This does not mean that they should be chartered accounts or belong to the finance profession. It would suffice if they have reasonably good familiarity with, and knowledge or experience of reading and understanding financial statements. The three financial statements, which are of critical importance from the point of view of the audit committee, are company's balance sheet, income expenditure statement, and cash flow statement. If it is not possible to get such financially literate persons on the audit committee, the company should arrange for appropriate training for the concerned directors. As soon as a new board member joins the audit committee he should be given the required background information about the company, including its products and services and the nature of business risks it faces.

Although the concept of audit committee is not of recent origin in countries like the US its role has been continually evolving and the activities covered by the audit committee's mandate have been periodically growing and becoming more important. In the early days of the audit committees, the committee was required to undertake primarily three functions: (i) review annual accounts and audited statements and submit them to the board with its comments and recommendations; (ii) review the findings/reports of the internal auditors and the statutory auditors; and (iii) maintain an appropriate interface with the management in regard to the internal control mechanism of the company vis-à-vis the accounts and audit functions.

But as the business and economic climate became increasingly more complex, regulatory requirements became more demanding, and as the public pressure grew for greater corporate accountability the dynamics of the audit committee has been continually changing. With gradual dismantling of national trade and tariff barriers and growing freedom in the movement of capital including direct investments across national borders, markets for commodities and capital are becoming increasingly global. With that the risks of doing business have grown substantially. Company managements have to cope up with growing complexities of managing business within the country and globally as these have to be in conformity with more rigorous cross border accounting standards and often highly demanding regulatory requirements. A highly competitive and expanding global economy creates opportunities for more complicated frauds which do not get easily detected in time. During recent times several countries have witnessed massive frauds and sudden business collapses. In fact, a few such well publicised frauds and failures in the UK led to the setting up of the now famous Cadbury Committee. In several countries there have been vocal demands in favour of adopting tighter accounting standards and practices, full and fair disclosures of accounts and financial results, and adoption of high ethical standards by the company managements. Shareholders want the boards to function more efficiently and keep an effective check on the executive directors, some of whom have a weakness for rewarding themselves with higher remuneration and various perks at the expense of the shareholders or pursuing empire building designs that do not benefit shareholders or the stakeholders.

One of the important tasks of the audit committee is to ensure active and independent oversight of financial reporting. The audit committee should also continually evaluate management effectiveness, internal control mechanisms, and risk management and risk containment policies. The guiding principles that the audit committee is supposed to follow are not company specific but applicable to all companies irrespective of their business activity. The members of the audit committee can and do add real value only when they are independent and candid in their approach to all the issues that are brought to their attention by the internal and the external auditors. The audit committee is not supposed either to prepare the accounting statements or get involved in all those mechanisms that go into the preparation of the accounts. The main task of preparing the accounts is that of the senior management and the staff of the company. For effectively carrying out its functions of monitoring and surveillance the audit committee is expected to rely on the internal and the external auditors. The audit committee's oversight is very crucial in evaluating the process of business strategy formulation and corporate goal setting, the appropriateness of company's accounting policies, and the rigour of internal controls including management controls.

The audit committee should exercise due diligence in the selection of the external auditors for the company before recommending their name to the board. The committee should also ensure that the internal audit team set up by the company is well qualified for the task on hand, in case the company does not intend to appoint a suitable professional accounting and audit firm to take up the internal audit activities. The audit committee should hold at least three to four meetings a year and interact with both the internal and external auditors.

Appointment Committee

Since the composition of the board is the key to the quality of corporate governance the process of selecting the directors who are not necessarily the representatives of the promoter shareholders is very much important. The Indian experience so far has shown that most of the family run companies have preferred to invite people on the board who are likely to toe their line. Often there is a gentleman's understanding that such invited directors do not raise inconvenient questions on the performance of the company or the way business is conducted. Hence, quite often, important operational matters are either not reviewed or reviewed in a perfunctory manner at the board meetings. There is, therefore, hardly any monitoring or review of operations either by the board or any of its committees. Appropriate changes in the Company Act are necessary to make it mandatory for all the companies above a particular size to have independent directors on the board. Therefore, in addition to having an effective audit committee, the boards should appoint another committee called the appointment committee, which should play a crucial role in the induction of new board members to fill in the vacancies caused by directors who retire. The appointment committee should also get closely involved in the appointment of senior executives of the company including the full time or executive directors. The appointment committee should be screening and doing due diligence of the short-listed suitable names before making its recommendations to the full board for approval. In the absence of such appointment committees it will not be possible to change the current ethos of the boards, which are functioning as the cosy and convenient clubs ratifying all that the promoters want to do.

Remuneration Committee

Although the remuneration paid to the directors, other than the sitting fees to the non-executive directors, are required to be approved by the shareholders in their general meeting the currently adopted process of fixing remuneration leaves much to be desired. In reality, the shareholders (other than the promoter shareholders) have rarely any voice in such matters. Even in countries like the US the remuneration packages of the executive directors had become a matter of great contention especially before the remuneration committees came to be accepted.

The main purpose of having a remuneration committee is to lend an element of objectivity to the process of determining remuneration package of the full time directors and the senior executives. If a company has a powerful chief executive or chairman-cum-managing director he is likely use his position to get his remuneration fixed at a level which may be higher than justified. The process of remuneration fixation of the full time directors and the senior executives is likely to be done more objectively in the case of a company that has a specially constituted board committee composed mainly of the independent directors. The remuneration committee may be expected to keep in view the scale and complexity of the business of the company and the relative performance of the executive directors and senior executives. The yardsticks chosen for the purpose of assessing effectiveness of the executive directors may preferably be return on net-worth and return on capital employed by the company. The remuneration may be benchmarked vis-à-vis remuneration levels in similar companies in the same industry/area of operation. In short, the remuneration levels should stand the tests of reasonableness and fairness by the prevailing industry standards.

The remuneration payable to the non-executive directors, other than the sitting fees, should be deliberated at the full board level. For ensuring effective participation and involvement of the non-executive directors they need to be rewarded suitably depending on the size and complexity of business of the company. The independent board members who constitute the four important committees viz., the audit, appointment, remuneration, and investment committees should be rewarded for the additional time spent by them for the company. These directors may have to devote sufficient time to understand all the complexities of the company's business. For this purpose, they should hold dialogues with the concerned executives of the company. After their close and in-depth study of the company, they should submit periodically reports to the board as to whether appropriate structures of accountability, accounting standards, compliance with all the legal and regulatory requirements, etc. are maintained. As a general guiding rule, independent directors should be compensated at rates higher than those the company would have paid for the services of similarly qualified outside consultants. The remuneration should depend on the number of hours or man-days that the independent directors would have to normally devote to the business of the company.

As per the recent amendment to the Companies Act the non-executive directors are now considered to be officers of the company. Unlike the consultants, the non-executive directors carry significantly much higher risks and will be held fully accountable for all the lapses on the part of the company. Highly experienced and competent persons who can make very useful contribution as independent directors would shy away from the responsibilities as directors would, if they are not suitably remunerated.

Investment Committee

Companies that have large liquid funds to manage or implementing large expansion/diversification projects should have an investment committee. There have been several instances in the past when a number of companies have suffered losses by lending funds in an informal inter-corporate lending market. During the securities scam of 1991-92 several companies including the PSUs were found to have not observed the prudential guidelines in deployment of funds raised by them from the market. Similarly, term lending institutions have noted that a large number of companies that take up new, expansion and/or diversification projects have often been noted to be lax in their project monitoring and implementation leading substantial cost and time over-runs. Given the reality of the Indian situation a close and effective monitoring by a specially constituted board committee is necessary to manage and deploy liquid funds as also of new/expansion/diversification projects.

Nature of Board Supervision

In India the boards are often not in a position to play their role effectively mainly because the company managements do not want to take all the board members into confidence on most of the important matters concerning the company. In a number of cases the companies adopt a highly simplistic approach: do not share with the board the matters, which you cannot share with the public. The boards are often viewed with suspicion and *confidential matters* are not shared with them. One of the possible reasons for this approach may be the fear that the information so provided may not remain confidential. Quite often the main reason appears to be that the executive directors and the promoters do not want to subject themselves to the board scrutiny. They may not often be able to satisfactorily explain the rationale of their policies or decisions and hence the wish to shroud them in a veil of secrecy.

Fear about confidential commercial information leaking out to the competitors is most of the time irrational. Given the fact that the employee turnover has become quite high and the possibility of the employees in the know of such confidential information being hired by the competitors cannot be ruled out it is really very difficult to keep all commercial secrets under wrap. The recent amendments to the Companies Act have made the non-executive directors as much accountable as the full time directors. It would, therefore, be irrational to expect that really competent persons would be ready to shoulder the risks that a company directorship poses, unless they are fully familiar with the intricacies of its business and have participated in the decision making process concerning all the important matters.

Suitable changes in the Companies Act should made so as to mandate companies to involve all the directors in the following key functions as delineated by the OECD principles:

- Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
- Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
- Reviewing key executives and board remuneration, and ensuring formal and transparent board nomination process.

- Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
- Ensuring the integrity of corporation's accounting and financial reporting systems, including independent audit, and the appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.
- Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.
- Overseeing the process of disclosure and communications.

It is desirable that suitable agenda items on all the above mentioned subjects are put up to the board for its consideration and the board is encouraged to discuss them thoroughly before decisions are taken. In order to make functioning of the boards more productive, a number of the above functions should be delegated to specially constituted committees of the board. The board committees should be expected to deliberate on matters under their purview thoroughly before putting up their recommendations to the full board for its consideration and approval. As discussed above, the items where the management of the company is not likely to be fully objective, the board should delegate such matters to the committee of independent directors for reviewing and reporting on management decisions.

In the Indian context in which a large number of companies are family controlled (even where the promoter families do not have majority ownership/shareholding), there are inherent risks that the interests of the dispersed majority shareholders may not receive due attention from the management. One indication of this may be found in the excessively high premiums that the controlling shareholdings command in India. The returns to those who control the management of companies do not appear to be mainly by way of what the other shareholders are rewarded. Hence, there is a pressing need in India to ensure that company boards are constituted with majority of independent directors. The independent directors can be expected to act as check on management from misuse of executive powers. They have a major role to play in such areas as executive remuneration, succession planning, take-over matters, mergers and acquisitions, purchase of high value assets (especially when projects are being implemented) or de-mergers through disposal of high value assets.

In India a large number companies hold their board meetings at long time intervals during which the non-executive directors do not get any feedback from their companies. Some companies hold barely four meetings in a year as required under the law. It should be made mandatory to have at least six board meetings year for large companies having diverse range of activities. To facilitate better participation of all the members in the board meetings suitable legislative changes need to be brought about so that members can attend board meetings through video conferencing facilities. Sometimes the time interval between two board meetings is more than four months. This would significantly facilitate Indian companies that are globalising their outlook and operations and inviting eminent foreign citizens to join their boards.

Non-executive directors of companies that are not in a position to hold board meetings with time intervals of less than three months are at a disadvantage and cannot fulfil their fiduciary responsibilities properly. Sometimes they feel it odd to

learn about major development affecting their companies through press reports, which may not often be covering the developments properly or accurately. It would be unfair to keep the board members in the dark about all the major happenings during such long time intervals. It should, therefore, be made mandatory for companies to send their reports periodically on important developments during such long time intervals if a company is not in a position to hold board meetings more frequently. Such reports prepared for the use of the non-executive directors should preferably be event based so that as soon as any important development concerning the company takes place the board members are kept fully informed about it.

Well-managed companies may not have to make special efforts to prepare reports for the benefit of the non-executive directors as such companies would certainly have their well-designed internal management information systems, based on which such reports can be prepared. The reporting formats of such reports for the board members may be decided by the board itself depending on the nature of business of each company. If some of the board members so desire to discuss certain matters and seek further clarifications they should have access to designated key officers of the company such as company secretary, finance director, or the internal auditors. The reasons for facilitating such an interaction is that the board members should get accurate, relevant and timely information about the company. The board should however, ensure that any of the individual directors do not interfere with the day to day management of the company. Board members should ensure that they have a constructive interaction with senior officials of the company only to the extent of fulfilling their fiduciary responsibility vis-à-vis the company, its shareholders and stakeholders. The non-executive directors should encourage and support the entrepreneurial spirit and functions of the executive directors.

PART III: Corporate Governance in Government Owned Entities

So far the discussion was concentrated on the general principles of corporate governance in entities where the boards of directors are expected to be accountable to the shareholders and are required to be protecting the interests of both the shareholders and the stakeholders. In the case of a private sector company the shareholders are expected to play their due role in electing a board which conveys this singular and clear objective without difficulty to the executive management of the company, including the whole time directors. This clarity also permits the board and the management to focus on the objectives without much confusion; it also facilitates setting up of systems for monitoring and evaluating management performance especially through various committees. In this framework the owner-management or 'principal-agent' chain is clearly spelt out and the accountability of all the parties involved is unambiguously defined. In short, it should clearly mean that the management is immediately accountable to the board and through the board to the owners, while the board is directly accountable to the owners.

Improving quality of corporate governance in government owned corporate entities is very much important for the simple reason that they account for major part of the organised economy in India. In terms capital employed and value added the public sector companies account for nearly one-half of the total. In so far as the financial sector is concerned, the significantly important role played by the public sector banks including the FIs is quite obvious. Any steps to improve corporate governance in the

Indian economy would remain half-hearted unless the government owned financial and non-financial corporate entities are also covered in this exercise.

In the case of government ownership, often the objectives are multiple, vaguely defined and may be often non-congruent. For example, in the case of public sector banks there are the objectives of assistance to the weaker sections of the society, subsidising poverty alleviation schemes, extending predefined levels of assistance to 'priority sectors' like small scale industry, agriculture, transport operators, exports, etc. Because of the plethora of guidelines and directives that periodically flow to the banks, often it becomes difficult to develop meaningful strategies for their achievement within the overall frame of good corporate governance as delineated above.

In reality far more complex problems arise especially because of the layered and hierarchical principal-agent structure that characterises the pattern of public sector ownership. The ultimate owners of public sector entities, viz., the voters, express their interests/ objectives in a diffuse, indirect, and cluttered up manner. However, when the governments/politicians act on behalf of the owners or the voters to crystallise owners'/voters' interests in terms of specific objectives, they are prone to cloud these objectives to the extent that their self-interests influence interpretation of voters' objectives. Since governments/politicians act as 'principals' through civil service, another layer is added to the 'principal-agent' chain. Civil servants too are liable to act as 'agents' by allowing their own objectives to dominate their actions during administration of public entities.

Multiple layers of 'principal-agent' chains in the case of government owned entities have important consequences for the corporate governance mechanisms adopted by them. Firstly, the 'agency' problem is aggravated with the possibility that the managements of the government owned entities may also pursue their own interests which may not necessarily reflect the will of the primary owners. Available evidence about government owned entities around the world shows that the layered and hierarchical ownership structure, and inadequate interest of 'surrogate' principals to effectively monitor performance of the government owned enterprises leads to an erosion of ownership identity. This causes weakening of the accountability process, since monitoring and evaluation become fragmented and unfocussed. In the vacuum caused by weak ownership, employee unions step in to establish 'proprietary' rights for employees in the government owned entities.

The problems arising from the multiple layering of the principal-agent relationships in the case of fully or majority government owned units could be resolved to a large extent by strengthening the governance mechanism at the board level and by ensuring high level of autonomy to the boards. The first important step should be to strengthen the boards of government owned entities by streamlining the process of appointment of truly independent directors. Government needs to establish a credible and result-oriented mechanism for identifying and nominating executive and non-executive directors. If boards have to function as effective instruments for putting in place desirable and effective corporate governance mechanisms, it would be important to ensure that the calibre, qualifications, and experience of the directors comprising the boards should be equal to their tasks.

The present non-transparent process of identifying and nominating directors on the boards of companies owned by the government needs to be replaced by a credible institutionalised system. The selection process of the eligible persons for board appointment should become the responsibility of a specifically constituted body of eminent experts on the lines of the Union Public Service Commission. This expert body may consider taking help of professional bodies in the fields of accounting, management, law, and relevant technical areas. As far as possible the temptation to appoint officers of the concerned administrative ministries on the boards of government owned entities should be avoided. Instead, the role of the administrative ministries should be limited to appointment of directors recommended by the expert committee and issuing of general guidelines to the corporate units under their jurisdiction. The boards should enjoy full autonomy in corporate governance and there should not be any day to day informal or formal interference with the managements of the units and with their day to day functioning.

The primary responsibility of the administrative ministry should be to issue written guidelines/directives to companies under its jurisdiction in so far as they are expected to reflect the 'will' of the ultimate owners (that is, voters) as perceived by the administrative ministries. For this purpose, the administrative ministry should prioritise its objectives and expectations and hold the managements and boards responsible for their achievements. All such guidelines/directives should be made transparent and made available to the general public. High level of transparency in this area would certainly have a desirable impact on the process of formulation of the guidelines/directives meant for the government owned entities. In other words, full transparency may be helpful in resolving some of the problems that arise from multi-layering of principal-agent relationships that cannot be avoided in the case of government owned units. The administrative ministries should monitor and review performance of the boards of the units keeping in view, inter alia, these transparent guidelines/directives.

In the interests of improving quality of corporate governance and operational performance of government owned units, the government should shift its emphasis from controlling management actions to monitoring their performance and results. Such a shift in emphasis would also cause the government to give up direct and detailed control of such units on a day to day basis, and adopt a somewhat 'arms-length' approach to their oversight. Competition faced by the government owned units is growing and becoming intense after the initiation economic deregulation during the early part of the last decade. While the manufacturing enterprises are facing competition from cheaper imports the public sector banks are facing competition from the newer banks set up by the institutions and the private sector. The government owned companies therefore need to be given much greater freedom to adopt newer and more efficient business practices, to freely exercise managerial judgements, to move quickly, to innovate, and to experiment if they are to successfully cope up with competition from domestic and foreign entities. This is possible only when they are given the much-needed autonomy, greater reliance on board management, and accountability to 'owners' though results than actions.

Experience so far indicates that partial change in the ownership through piece meal divestment of government holdings and sale of minority stake in some of the companies has not brought about any visible improvements in their operational

performance or quality of their corporate governance. This holds good in regard to almost all the units irrespective of whether the government has divested small or substantial part of its equity holdings. Presence of non-government holdings in varying proportions has hardly made any difference to the management style of these enterprises because government continues to hold all the reins in its own hands.

(a) ***Corporate Governance in PSUs***

In India the central and the state governments have major presence in many areas which were not their traditional activities until the time of Independence. A significant shift in the policy took place in the early 1950s when the country adopted the process of planning for stimulating economic development. Government started assuming increasingly much greater role by setting up its wholly owned units in several important industries which were considered by it to be core industries for stimulating growth process in the economy. But as the years passed, government widened its canvas and started investing in non-core sectors like luxury hotels and food processing. This strategy favoured public sector occupying commanding heights in a large number of industries so that the public sector units emerged as the dominant players in their respective areas of operations. Several capital intensive and large industries were classified as the core sector industries in which the public sector was designed to be the sole or the major player. Many of these sectors like iron and steel, electrical goods, machinery manufacturing, machine tools, are not even in the nature of natural monopolies (like transmission and distribution of electricity) or socially oriented sectors (like health facilities for the poor). It is only in respect of natural monopolies or socially oriented activities that government involvement may be considered to be necessary or inevitable. But this cannot be said about the Central and the State government investments in less important industries, which are in direct competition with the private sector.

A pertinent question that may be raised in this context is, whether the corporate governance norms considered appropriate for the companies should also be made applicable to all the public sector companies as well. The Group recommends that, although the activities undertaken by the government departmentally are subject to the scrutiny of the Parliament/State Legislatures when budgetary allocations are sought for them, the basic principles of the good governance especially relating to transparency and disclosure should be respected and observed by the government even in the management of departmentally undertaken activities. Further, there is a strong justification that all entities set up by the Central and State Governments under the Companies Act to undertake any commercial, non-commercial or socially-oriented activities should be subject to all the norms of good corporate governance as are applicable to the private sector corporate entities.

The Central and the State governments have set up a large number of companies for taking up commercial as well as non-commercial activities. Most of the large public sector units established for taking up industrial and commercial activities have been set up by the Central government. Some of the state governments like Karnatak have also set up a number of industrial and commercial units as companies. Most of the state governments have set up corporate units to take up such non-commercial activities as improving the lot of weaker sections of the society or for stimulating economic development in less developed areas. Although these entities are not expected to be driven by profit motives there is no reason why they should not be

asked to adopt good corporate governance mechanisms such as professional boards, independent directors, and board committees comprising independent directors for overseeing important activities, etc. In any case, they should be subjected fully to the principles of transparency and full disclosure as they are using public resources. If it is felt that such activities need not be subjected to the discipline of all the principles of corporate governance there is no reason why the governments cannot take up these activities departmentally.

Many problems in regard to the quality of corporate governance noted in the case of the typical family controlled private sector companies in India not only exist in the PSUs but some of them get accentuated. As noted already, the family controlled managements often do not bother about the interests of the rest of the shareholder community. In the case of the PSUs where there is private shareholding in varying proportions the board decisions do not reflect adequate concern for these shareholders. When the divestment process in PSUs started quite some time ago in small trickles there was a great fancy among investors to subscribe to shares of the PSUs. But over time, the sharp fall in the prices of the PSU shares has shown that those hopes were not based on any realistic assessment. Weakening confidence of the markets in the quality of corporate governance of the PSUs is largely responsible for their share prices to be quoted at heavy discounts in relation to their intrinsic networth. Several PSUs, which have not made any public issue of equity capital are also not managed in such a way that they satisfy the considerations of social equity or economic efficiency. While grossly mismanaged and loss making private sector units will be eventually forced to close down and would not remain a continuous drag on the community's resources, the PSUs are continuing to survive with subsidy from the government in one form or the other. Because of the political compulsions and the pressures from the militant trade unions the concerned administrative ministries avoid difficult decisions like closure or downsizing of loss making units.

The initial euphoria about the PSUs in the late 1950s and the 1960s has cooled down. The government appears to have recognised the need for divesting its stake in many of these PSUs. But the problem of poor corporate governance continues to be intractable. With growing competition, as a result of domestic deregulation and lowering of trade and tariff barriers, the PSUs are finding that they will not remain viable unless they respond to market realities and growing competition. Hence, the PSUs should be given high degree of internal autonomy and freedom to respond to market forces expeditiously. To build investor confidence they should, *inter alia*, be allowed to operate in a framework that facilitates good corporate governance.

The management of a typical PSUs has to contend invariably with a plethora of directives, guidelines, and almost day to day interference from the officials at various levels of the concerned administrative ministries. Several governmental agencies including the administrative ministries frequently issue written and oral instructions as to what the PSUs should or should not do. The full time directors and the CEOs of the PSUs find it difficult to counter these pressures as their boards enjoy very little autonomy and are not really in charge of their governance.

Periodically, attempts have been made to upgrade the quality of corporate governance of the PSUs. During the 1980s the government accepted recommendations of some of the high powered committees in regard to reconstitution of the PSU boards and a

decision was take to implement them. The proposed changes had required that every board should have full time directors in the fields of finance, personnel, etc., and their number should not exceed one half of the strength of the board. It was also required that the number of government directors should not exceed one-third of the board strength while the strength of the part-time or professional directors should not be less than one-third of the board strength. The concerned administrative ministries, however, have not implemented most of these rules. In particular the crucial requirement in respect of the non-official or professional directors has been invariably ignored.

The operational freedom of the full time directors is curtailed at the whim of some of the administrative ministries. For example, the CEOs of some of the highly profitable PSUs were recently directed to seek approval of the administrative ministry before an official of the company was to be sent abroad for any official business, or even technical training. Sometimes approvals for such purposes are given after the event, making such approvals meaningless. The delegation of powers to executive directors of the PSUs is highly restrictive and even the boards do not have the necessary powers in this regard. Most of the important matters have to be referred to the concerned administrative ministries and often the decisions are delayed for no apparently justifiable reasons. Most of the important decisions affecting the PSUs are taken outside their boardrooms. In short, the governance of the PSUs is a typical case of back seat driving and the boards are a mere formality or a rubber stamping authority.

The major reform that needs to be brought about in respect of the PSUs is how to make the boards more professional and autonomous by freeing them from excessive and detailed day-to-day control of the concerned administrative ministries. It is desirable that the Parliament and the government give their maximum and concentrated attention to the most important role of formulating the overall policy framework and goal/target setting for the PSUs. Corporate governance should be transferred back to the boards from the administrative ministries. The boards of the PSUs should be given full autonomy and made the focal point in the area of corporate governance.

A major step for improving corporate governance of the PSUs is to set up an independent high-powered Selection Board of eminent persons to select full time or executive directors for boards of the PSUs. The selection board should be constituted on the lines of the Union Public Service Commission with requisite high standing and independence. The decisions of this Selection Board regarding choice of persons to be appointed as executive directors and other directors on the boards of the PSUs should be final and the concerned administrative ministries should merely be the formal appointing authorities. The Selection Board should also prepare a panel of experts for nomination as independent or professional directors on the boards of the PSUs. For this purpose the Selection Board may seek the assistance of professional bodies like the ICAI, ICSI, and similar professional bodies in the area of engineering and technology. The Selection Board should periodically review and expand the panel of experts in different areas for appointment as independent directors on the boards of the PSUs. After the major one time exercise of reconstituting the PSU boards is completed, the subsequent reconstitution of the individual PSU boards should be done as far as possible, in consultation with the appointment committees of those respective

boards themselves. The role of the Selection Board should be one of monitoring and supervising the whole process in such a way that it adopts a policy of ***management by exception***.

PSU boards should also adopt the system of having at least the four board committees, viz., audit committee, nomination committee, remuneration committee and investment committee. The PSUs should be freed from the current practice of uniform pay scales irrespective of their complexity or size of operations or their profitability levels. The PSUs that are profitable and do not depend on government funding should have the freedom to determine remuneration packages for their employees including the working directors. Such packages may contain two components, one of which is directly linked to their profitability performance. With such a compensation package the salary levels will automatically get adjusted upwards or downwards depending on the trends in the profitability levels. So long as the PSUs do not seek subsidies or government funding for their expansion and diversification plans, their boards should have freedom to approve all the expansion or diversification plans. It is very much essential to ensure that the executive and non-executive directors owe their first allegiance to their company rather than the concerned administrative ministry of the PSUs.

(b*) Corporate Governance in Banks & DFIs*

The issues relating to corporate governance in banks received a back seat especially after the major banks were nationalised in two phases and several social obligations were placed on them. The same may be noted in respect of the government owned term lending institutions or the development financing institutions (DFIs). All these entities became an instrument of national economic planning. The resources mobilised by the banks by way of deposits were increasingly allocated in favour of the government through fiats. SLR and CRR were raised periodically and along with that the credit allocations to certain priority sectors were also continually raised.

As a part of economic liberalisation the pre-emption of resources by way of SLR and CRR have been substantially brought down during last decade. Simultaneously, the other guidelines/directives issued by RBI to the banks in regard to credit/deposit ratios, lending to various sectors (other than the priority sectors), etc. have been substantially liberalised. But in tune with all the changes the quality of corporate governance has not improved as the current overall policy frame work in this area remains rather antediluvian.

Currently, in India about four-fifths of the banking business is under the control of public sector banks (PSBs), comprising the SBI and its subsidiaries and the nationalised banks. The government ownership of such a large chunk of the banking sector creates a number of problems for the RBI as the regulator of the financial system. The problems are particularly complex because government often acts as a quasi-regulator. Corporate governance in public sector banks is complicated by the fact that effective management of these banks vests with the government and the top managements and the boards of banks operate merely as functionaries. The ground reality is such that the government performs simultaneously multiple functions vis-à-vis the PSBs, such as the owner, manager, quasi-regulator, and sometimes even as the super-regulator. Unless the issues connected with these multiple, and sometimes conflicting, functions are resolved and the boards of banks are given the desired level

of autonomy it would be difficult to improve quality of corporate governance in public sector banks.

Even when the government dilutes its holdings to bring them significantly below the threshold limit of 51%, efforts to institute good governance practices would remain at superficial level unless the government seriously redefines its role de novo. Recent announcement by the government that its holdings in nationalised banks would be brought down well below the critical level of 51% may not necessarily lead to any significant change in the way the PSBs function. Government itself has affirmed that the public sector character of these banks would remain unchanged even after it ceases to have majority ownership. Even after dilution of its stake in the PSBs the government would continue to be the single largest and dominant shareholder. The changes proposed in the composition of the boards would result in government directly appointing 9 out of the 15 directors including the 4 whole time directors. Moreover, the voting rights of any of the other shareholders will continue to be restricted thereby negating the basic principle of equal rights to all the shareholders.

As things stand today, there is no equality among the various board members of the PSBs. Nominees of RBI and GOI are treated to be superior to other directors. There are certain committees of the PSB boards, which cannot function unless the RBI/GOI directors participate. The Audit Committees of the banks currently are functioning more as super inspection departments. They are more preoccupied with audit ratings earned by different branches rather than looking at the MIS and data as tools for evaluating management policies and strategies. The audit committees of the PSBs should be giving much greater attention to the true audit functions including audit of management policies, internal control mechanisms, risk management policies, and their implementation/effectiveness. Rights of private shareholders' of SBI/PSBs are abridged considerably since their approval is not required for paying dividend or adopting annual accounts. The subsidiaries of the SBI enjoy very limited board autonomy as they have to get clearance on most of the important matters from the parent even before putting them up to their boards. Preferential treatment accorded to the government nominee for purposes of quorum at the AGM of PSBs could be noted from the fact that the AGM cannot be conducted without the presence of the government nominee. The over-arching role of the government with its multiple dimensions needs to be reviewed and redefined. Unless this is done, any efforts to institute good governance practices would be of limited consequence. The role of RBI as a regulator to improve quality of corporate governance will continue to remain considerably handicapped.

As a matter principle, it is incongruous on the part of RBI as the regulator of the banking system to appoint its nominee/s on the boards of the regulated entities. Therefore, in its role as the regulator RBI need not have representation on the bank boards given the fact that it leads to conflicts of interests with its regulatory functions. RBI in its endeavour to achieve trade-offs between stability and excessive (unhealthy!) competition lends itself in the situation of moral hazard. To avoid such situations and encourage good corporate governance RBI needs to avoid its officers sitting on the boards of the banks. This should apply even in the case of SBI where RBI is the major shareholder. If necessary, RBI may consider appointing independent outsiders as its nominees on the boards of SBI. RBI has already started withdrawing

its nominees from the boards of banks. It is suggested that it should complete this process as early as possible.

All over the world banks and financial institutions are not put on par with the rest of the corporate sector for several reasons. They are a major source of funding to all economic activities. The importance of these institutions is underscored by the fact that they are the backbone of the national payment system. Given their importance to the economy these financial intermediaries are under the regulatory purview of the central banking institution in most of the countries and, in times of distress, they are given access to the safety net by the central bank or the government. Provision of the safety net becomes inescapable especially to preserve the integrity of the payments system and protecting the interests of the depositors. In view of this, any policy measures to protect banks that are less careful in their lending policies at the cost of tax payers' money need to be tempered in such a way that they do not encourage profligate lending by banks.

Effective regulation of the banking institutions to dissuade them from unwise and high risk lending is highly essential because they are invariably highly leveraged. The total liabilities of these entities are on an average 8 to 12 times their net-worth. All these entities are expected to maintain a given minimum level of capital adequacy, which is defined as a relationship between their owned funds (net of all provisions) and their risk weighted assets. In India, banks have to maintain certain minimum level of cash reserves (CRR) and investments in government or government guaranteed bonds (SLR) in relation to their deposit base/liabilities. Although no formal government guarantee is provided to the depositors, there are rare occasions when a banking institution is allowed to go burst. The universal worry is that failure of a large bank may undermine stability of the financial system of the country.

Authorities also do not favour a free market in take-overs in respect of the banks and institutions. Given these major differences as between banks and other corporate entities, the good corporate governance practices that should be adopted by them may have to be somewhat different from those applicable to other corporate entities. Incidentally in Belgium while registering with the Banking Commission, the dominant shareholders or promoters of banks have to sign a protocol of managerial autonomy giving a commitment that they will not in any way interfere with the freedom of the management and the board of directors. The same should be assured in respect of banks and the FIs in India by their major shareholders including the government and RBI (in respect of SBI).

As the regulatory authority of banks RBI has a special role to play in upgrading quality of corporate governance in all banks including the PSBs. Like the other central banks, RBI has been laying stress on five major aspects of governance in banks, which are briefly described as CAMEL, meaning thereby, Capital adequacy, Asset quality, Management, Earnings, and Liquidity. One can argue that the principles of good corporate governance are embedded in one of the five factors viz., management. But this term alone does not convey the full meaning of what is defined to be good governance. In the light of the OECD principles, the Basel Committee on Banking Supervision of the Bank for International Settlements (BIS) has issued a framework of good corporate governance for banks. It has endorsed almost all the major recommendations contained in the OECD principles. In regard to the board

committees, in addition to the three important board committees viz., audit committee, nominations committee, and compensation (remuneration) committee the BIS committee is in favour of one more committee called risk management committee. Given the nature of banking business, the risk containment strategies in such areas as management of interest rate risk, effective internal control systems, and management of credit risk are very much crucial. The Basel committee has laid emphasis on banks having clear strategies for their operations and establishing accountability for executing them. It is also in favour of a high degree of transparency and disclosure of information, which should enable others to judge management quality of the bank.

Given the fact that banks and institutions are highly leveraged entities and that their failure would pose grave risks to the entire financial system with attendant adverse impact on the rest of the economy, the corporate governance systems should have to be much tighter in banks and financial institutions. But, the reality is quite different in India. Although RBI maintains a tight vigil and inspects these entities thoroughly at regular time intervals, the quality of corporate level governance mechanism does not appear to be satisfactory. One of the major factors that impinges directly on the quality of corporate governance is the government ownership. Many of the problems noted in respect of the PSUs also affect the functioning of the banks. Added complication has been that the banks and institutions are covered under several Acts of the Parliament. These are (1) SBI Act, (2) Bank Nationalisation Act, (3) IDBI Act, (4) Banking Regulation Act, (5) RBI Act, and the (6) Companies Act. It is desirable that all the banks are brought under a single Act so that the corporate governance regimes do not have to be different just because the entities are covered under multiple Acts of the Parliament or that their ownership is in the private or public sector.

The Bank Nationalisation Act vests the general superintendence, direction and management of PSBs in their respective boards. At the same time, the Act also requires that PSBs will be guided by government directions in matters of policy involving public interest. Over the years, government directions have often been beyond ***'matters involving public interest'*** and include the whole gamut of administrative and corporate activities of the PSBs. Since most of the directors on the boards of PSBs are government appointees/nominees without well defined functions and powers, none of the PSB boards have ever attempted to test their powers under their Act.

Another major problem affecting banks has been the representation given to the various interest groups on the boards of the banks. The main objective behind these representations was to give voice to various sections of the society at the board level of the banks. This was felt to be the right approach to management of banks during the early days when the country had adopted a comprehensive planning for economic development "with social justice" and the nationalisation of the major chunk of the banking sector. With the launch of major economic reforms during the last decade, the relevance of many of such provisions has become much less relevant and productive. Secondly, it has now become clear that many of these provisions are not fully in conformity with principles of good corporate governance in banks and institutions. It has been observed that most of the nominees representing particular sectional interests argue vociferously in favour of their own narrow interests with

considerable disregard to the health of the banking institution as whole. It has also been noted that boards do not function in a manner that would lead to a healthy balance of the interests of the shareholders and stakeholders. In regard to the some of the private sector banks it has been observed that often the narrow community and regional interests take precedence over what is best in the overall interests of the banking institution.

Hence, a major reform is needed in the area of constitution of the boards of the banks. The chairmen, executive directors and non-executive directors on the boards of the public sector banks (including the SBI and its subsidiaries) need to be appointed on the advice of an expert body set up on the lines of the UPSC, with similar status and independence. Such a body may be set up jointly by RBI and the Ministry of Finance. As far as possible, the current system of giving chairmen and executive directors of banks an implicit seniority ranking and transferring them from their existing banks to "better/bigger" banks should be discontinued. This system makes the incumbents to be ever on the look out for moving to a "better/bigger" bank rather than improving governance of the banks they are currently serving.

There is also no need to have directors that represent narrow sectional and economic interests. All the objectives that the banks are supposed to achieve should become an integral part of the corporate mission statements of these institutions. All these objectives could be better and more effectively served through the issue of guidelines/directives to the PSBs and other bank boards by the RBI in consultation with the government. This should become the prerequisite for introducing good corporate governance in all the banks and institutions including public sector banks and institutions.

Independent Professional Directors

Current regulatory provisions do not permit a bank to lend money to a company if any of its board member is also a director on the board of that company. This regulation was introduced quite some time ago when the banks were mainly in the private sector and most of them were under the management control of one of the industrial houses. This rule was therefore introduced to prevent cornering of bank funds by the controlling industrial houses as also their possible misuse. This rule is today being indiscriminately implemented although the circumstances that warranted it may not be equally relevant or applicable in all cases. The negative impact of this rule has been that the banks are not able to get good professionals for their boards. Eminent professionals, from whose presence the boards of banks will benefit immensely, are not willing to join them because that would lead to denial of bank loans to all the companies where they happen to be on the boards. Incidentally, the term lending institutions like ICICI or IDBI do not suffer from similar handicap as these institutions are not prevented from lending to companies even when their board members also happen to be on the boards of companies receiving their loans. This archaic rule should be modified immediately so that the professionals who are on the boards of non-banking companies as professional or independent directors do not suffer from any handicaps. The current rule may however be continued only in respect of directors of companies who are their promoters and have a stake in their companies beyond being merely a director.

In this context, it needs to be recognised that the presence of government directors on the boards of public sector banks does result into conflict of interests whenever these banks are lending to public sector units. When such matters come before the boards of banks the government directors are, for all practical purposes, the interested parties. In the interests of good governance it is desirable that government directors should not participate in the discussion on such matters and also abstain from voting. In short, the government directors need to avoid influencing board discussions on all matters connected with assistance to public sector units.

Remuneration Levels
All the public sector bank salaries are negotiated industry-wide and almost uniform salaries (with some minor variations) are paid to the public sector bank employees, including the officers. The same holds good in respect of the salaries of the chief executives and other full time directors. No distinction is made in regard to the size of the banks, complexity of the problems facing individual banks, and their profitability levels. Since there is no incentive for good work, performance and profitability levels of most of the banks are showing almost continuous downward journey. To arrest this worsening trend and provide effective incentives for good performance the policy of uniform salaries across the public sector banks should be scrapped at the earliest. Each bank board should have full freedom to structure compensation package to its own employees and their periodic salary revisions should be linked to quality of their performance. However, if some banks want to conduct joint negotiations with their unions there need not be any bar in doing so. To attract competent professionals to the senior posts including the post of the CEO the compensation packages of the PSBs should reflect market reality.

PART IV: Prioritisation and Phasing

Prioritising of Actions
The pace of reforms in corporate governance would depend largely on the restructuring of the boards of directors of companies and banks. Most of the private sector companies in India belong to the ‘insider’ model where the ‘founding/promoter’ families control the entire corporate operations. The institutions and banks even in the public sector reflect similar form of governance that does not fully respect the rights of common shareholders. The boards of companies, banks and institutions should, therefore, be restructured and should be made truly autonomous and independent. In the case of private sector companies the boards should include majority of independent non-executive directors. In the case of PSUs, PSBs and the DFIs the boards should be reconstituted to make them more professional and their boards should become the focal points of governance.

Quality of corporate governance in India cannot be improved merely by manning boards with majority of non-executive directors. Ironically, most of the company boards in India already have non-executive directors in significant majority! The main reason why the quality of corporate governance in all such companies is not up to the mark is that most of these non-executive directors are hand picked by the promoters to suit their own convenience. Secondly, merely because there is a separation of the Chairman’s post from that of the CEO it should not mean that the number of independent directors on the boards should be less than one-half. In many family-managed companies the non-executive Chairman’s post is held by a person from the

promoter group itself. Before the Companies Act made it mandatory for companies with a paid up capital of Rs. 5 crore and above to have managing director, there used be a number of family dominated companies with boards composed only of non-executive directors. Hence, it is not realistic to assume that high proportion of non-executive directors would necessarily result in improving the quality of corporate governance. The crux of the matter is the proportion of truly independent directors on the corporate boards. For giving a major push to the reform process in corporate governance area, the Companies Act should be amended as early possible to incorporate all the reforms recommended above by this Group. Highest priority should be given to the legal amendments that would make it mandatory to have majority of independent directors and also board committees dominated by the independent directors.

Phasing & Time Frame

It is desirable that eventually most of the companies should have well-structured boards for upgrading their governance standards. However, a more realistic approach would be to concentrate our attention on bringing about the needed reforms in the medium and large companies (companies with net-worth of Rs. 5 crore and above) which account for major part of the corporate economy. It may be noted in this context that it is difficult to identify, in the immediate future, a large number of independent directors even if boards of only medium and large sized companies are to have majority of independent directors. It may, therefore, be necessary to implement this reform in phases over a five-year period. During the first phase of one year, the 100 largest companies by net-worth should be covered in this exercise. Over the next four years other large and medium sized companies may be covered in two or more phases so that all the medium and large companies at least get covered in this reform process.

The task of restructuring company boards could be better facilitated by setting up an institution called Institute of Company Directors (IOCD) which may be recognised as a self-regulatory entity by the Department of Company Affairs, GOI. The IOCD should be entrusted with the task of identifying and imparting necessary training to qualified people to take up the responsibility of independent directors. IOCD should be providing training and continuing education to the persons identified to work as independent directors on the boards of companies. IOCD should prepare a panel and comprehensive database of persons eligible to act as independent directors. The appointment committees of the company boards will find such a panel very useful for identifying appropriate persons for recommending them as independent directors to their respective boards.

Conclusion

The law prima facie protects the rights of the common shareholders at least in so far the private corporate sector companies are concerned. However, the shareholders' rights to vote and bring about desirable changes in the management and quality of corporate governance of private sector banks and the PSBs and PSUs that have gone public, stand considerably abridged. The mechanism to enforce shareholders' rights even in the case of private sector companies is rather weak. The company mangements can use methods like holding general meetings of shareholders at inconvenient locations etc., to effectively deny shareholders' rights. The enforcement of shareholders' rights and improving the overall quality of corporate governance can

be brought about through structural reforms in the constitution of the boards, board committees, appointment of independent directors, and transparency and full disclosures. Special attention needs to be given to improving quality of governance in the PSUs and the banking institutions where the government and the RBI have a major role to play.

Annexure

In the enclosed **Annexure** an attempt is made to present the current status of corporate governance in the private sector companies, PSUs, and banks separately, primarily with reference to international standards as delineated by the OECD principles. The **Annexure** also gives the changes/reforms needed in respective areas to improve quality of corporate governance in India so as to bring it on par with the best international standards.