REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

Corporate Governance Country Assessment

INDIA

April 2004

This Corporate Governance Assessment was completed as part of the joint World Bank-IMF program of Reports on the Observance of Standards and Codes (ROSC). It benchmarks the country's observance of corporate governance against the OECD Principles of Corporate Governance and is based on a template developed by the World Bank. The diagnostic was undertaken on the basis of the completed template prepared by the Confederation of Indian Industries. The assessment of practices is based on interviews with issuers, institutional investors, financial institutions and reputational agents, such as market analysts, lawyers, accountants and auditors. Acknowledgments are due to the Department of Company Affairs (DCA) and the inter-disciplinary Corporate Governance ROSC Steering Committee, the Securities and Exchange Board of India (SEBI), the Stock Exchange, Mumbai (BSE), the National Stock Exchange (NSE), the National Securities Depository and the Institute of Chartered Accountants of India. Olivier Frémond and Mierta Capaul of the Corporate Governance Group/Investment Climate Department of the Private Sector Vice Presidency of the World Bank drafted the final report. Priya Basu of the Finance and Private Sector Development Unit of the World Bank provided valuable guidance and, along with other peer reviewers, contributed constructive comments on the draft. Varsha Marathe of the Finance and Private Sector Development Unit of the World Bank in Delhi represented the team at meetings of the ROSC Steering Committee and provided helpful input to the draft, including the annex on the enforcement of shareholder rights. Victoria Korogodon provided research support and quality control. The ROSC assessment was cleared for publication by the Department of Economic Affairs (DEA) on June 25, 2004. The report has been discussed with the Government of India, but does not necessarily bear their approval for all its contents, especially where the Bank has stated its judgments/opinions/conclusions.

EXECUTIVE SUMMARY

Since the first Corporate Governance ROSC assessment dated July 31, 2000, a series of legal and regulatory reforms have transformed the Indian corporate governance framework and improved the level of responsibility/accountability of insiders, fairness in the treatment of minority shareholders and stakeholders, board practices, and transparency. In particular, the securities regulator introduced a corporate governance clause in the listing agreement that clarified many issues. Recent efforts to strengthen enforcement have enhanced investors' trust in the market. The financial press is increasingly reporting violations of shareholder rights. These are positive drivers of change. However, enforcement and implementation of laws and regulations remain important challenges.[1]

The aim of corporate governance reform is to create an enabling environment to ensure that that foreign and domestic long term "patient" capital is available to fund corporate growth and preserve private savings for retirement. The challenge for policymakers is to enhance market integrity by enforcing rules and regulations in a professional, timely, transparent and consistent fashion.

The report identifies several areas for reform: (1) Sanctions and enforcement should be credible deterrents to help align business practices with the legal and regulatory framework, in particular with respect to related party transactions and insider trading; (2) The current institutional framework places the oversight of listed companies partly with the Department of Company Affairs (DCA), partly with the Securities and Exchange Bard of India (SEBI) and partly with the stock exchanges. This fragmented structure gives rise to regulatory arbitrage and weakens enforcement. (3) Board practices need to be strengthened; (4) Institutional investors acting in a fiduciary capacity should be encouraged to formulate a comprehensive corporate governance policy, including voting and board representation. Together with the detailed policy recommendations, these measures will help implement reforms and provide opportunities for issuers to signal good practices to investors and the market.

I. CAPITAL MARKETS AND INSTITUTIONAL FRAMEWORK

In 2003, there were over 9,500 listed companies[2] and 23 registered stock exchanges in India. Since 1999, total market capitalization has hovered around 22 to 25 percent of GDP. The Stock Exchange, Mumbai (BSE) and the National Stock Exchange (NSE) are the two main exchanges competing with each other.[3] In May 2003, there were 5,650[4] companies listed on the BSE and 1,471 on the NSE,[5] 1,000 of which were actively traded. The top 100 BSE companies represented nearly 86 percent of BSE's market capitalization. NSE's trading volume accounted for 57 percent of its total. The average free float for the 1,034 BSE companies most frequently traded was 47 percent. 80 percent of trading volume is retail.

State owned enterprises accounted for 32 percent of BSE's market capitalization. The Oil and Natural Gas Corporation, for example, ranked first in market capitalization. In 2002-2003, six IPOS and 20 secondary offerings raised Rs 40.73 billion (USD 896 million).[6] There were 978

[1] Selected issues of enforcement of shareholder rights are discussed in Annex C.
[2] Source: DCA. This figure represents less than 2 percent of the total number of registered companies.
[3] Under the Securities Contract Regulation Act, 1956, all Indian stock exchanges have a self-regulatory role, but they may differ in organizational form. BSE is an "Association of Persons" and does not have a profit motive (although post-demutualization it will become a company), while NSE is a for-profit company. However, profit maximization is not the latter's exclusive goal.
[4] 2, 650 of which are suspended.
[5] Since multiple listings are permitted, there is some overlap between the companies listed on the NSE and the BSE.
[6] Exchange rate as of December 11, 2003; 1.00 Rs = .022 USD.

corporate deals for a total of Rs 337 billion (USD 7.4 billion), of which 362 were mergers and 21 takeovers. 69 companies had GDRs, 11 ADRs, and five companies[7] had both.

Traditionally, financing was debt driven, and Development Finance Institutions (DFIs) were an important source of finance. Equity financing is now growing, slowly modifying the ownership structure. Promoters[8] tend to own at least 26 percent of a company, as this threshold gives them veto rights in special resolutions. Business groups are common.[9]

The legal framework is based on common law. Firms are governed by the Companies Act (CA), 1956 as amended. The CA is administered by the Department of Company Affairs (DCA) and enforced by the Company Law Board (CLB) and the Company Courts. Listed companies must comply with the rules and regulations prescribed by the Securities and Exchange Board of India (SEBI) Act, 1992; with the Securities Contract (Regulation) Act, 1956; the Depositories Act, 1996; the Sick Industrial Companies (Special Provisions) Act (SICA), 1985; and the listing rules.

SEBI regulates the stock exchanges, stock brokers, share transfer agents, merchant banks, portfolio managers, other market intermediaries, collective investment schemes and primary issues. It prohibits fraudulent and unfair trade practices, and regulates the substantial acquisition of shares and takeovers. It is an autonomous body established under an act of Parliament, to whom it submits annual reports. The Cabinet appoints SEBI's board. SEBI's budget comes from fees, levies and government grants. Its decisions are subject to independent judicial review. SEBI is operationally independent, but the government can issue directions in policy matters.

Over the last few years, a series of joint corporate governance committees were appointed by DCA and SEBI. Their recommendations are reflected in CA amendments, listing rules and SEBI regulations. "Clause 49" of the listing rules addresses corporate governance on a "comply or explain" basis. All listed companies with paid up capital of Rs 30 million (USD 660,000) or with a net worth of Rs 250 million (USD 5.5 million) must comply with Clause 49. There are mandatory and non-mandatory requirements.[10] Two credit rating agencies rate the quality of corporate governance of issuers.[11]

II. REVIEW OF CORPORATE GOVERNANCE PRINCIPLES

This section assesses India's compliance with each OECD Principle of Corporate Governance. Policy recommendations may be offered if a Principle is less than fully observed or if good practices are moving beyond the OECD Principles.[12]

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[7] Dr. Reddy's Laboratories, ICICI Bank, Silverline Technologies, Videsh Sanchar Nigam, Mahanagar Telephone.

[8] A promoter is a person, family or group who controls a company and is involved in management decisions.

[9] For a discussion of Indian business groups see, e.g., Marianne Bertrand, Paras Mehta and Sendhil Mullaianthan, "Ferreting out tunneling, an application to Indian business groups," National Bureau of Economic Research, Working Paper 7952

[10] Clause 49 was implemented in February 2000. Revisions to Clause 49 were made in 2003; these revisions were held in abeyance by SEBI. This report is based on Clause 49 (2000).

[11] The two domestic rating agencies are CRISIL and ICRA.

[12] **Observed** means that all essential criteria are met without significant deficiencies. **Largely observed** means only minor shortcomings are observed, which do not raise questions about the authorities' ability and intent to achieve full observance in the short term. **Partially observed** means that while the legal and regulatory framework complies with the Principle, practices, and enforcement diverge. **Materially not observed** means that, despite progress, shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. **Not observed** means no substantive progress toward observance has been achieved.

Section I: The Rights of Shareholders

Principle IA: The corporate governance framework should protect shareholders' rights. Basic shareholder rights include the right to: (1) secure methods of ownership registration; (2) convey or transfer shares; (3) obtain relevant information on the corporation on a timely and regular basis; (4) participate and vote in general shareholder meetings; (5) elect members of the board; and (6) share in the profits of the corporation.

Assessment: ***Observed***

Description of practice: **Secure methods of ownership registration.** There are two electronic depositories: the National Securities Depository (NSDL) and the Central Depository Services (CDSL). Shares traded through a stock exchange are held in dematerialized form in the depositories.[13] Registration in a depository is proof of ownership.[14] Companies must maintain a register of shareholders or outsource this function to a share transfer agent.

Convey or transfer shares. Shares are freely transferable. Shares traded through stock exchanges are transferred through book entry at the depositories. Cash settlement occurs at the designated clearing banks of the stock exchanges' clearing houses. Clearance and settlement occurs in DVP2 on T+2[15]. NSE offers novation. Guarantee funds largely eliminate settlement risk.

Obtain relevant information on the corporation on a timely and regular basis. Annual and half yearly statements are mailed to shareholders; quarterly accounts are published in newspapers and posted on the websites of issuers and stock exchanges. Companies must file their memorandum, articles of association and financial information with a Registrar of Companies (ROC).[16] Investors can access this information for a nominal fee of approximately 1 USD. Shareholders may inspect the minutes of the Annual General Meeting (AGM).

Participate and vote in general shareholder meetings. Shareholders have the right to participate and vote at general meetings.

Elect members of the board. Usually, directors are proposed by the board and elected by shareholders.[17] Shareholders can also propose a candidate up to fourteen days before the AGM. The company must inform all shareholders about the candidature at least seven days before the meeting. In practice, shareholders seldom use this right.

Share in the profits of the corporation. The board of directors proposes the dividend, and the AGM approves it. Dividends must be paid within thirty days.[18]

Principle IB: Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes, such as: (i) amendments to the governing documents of the company; (ii) the authorization of additional shares; and (iii) extraordinary transactions that in effect result in the sale of the company.

Assessment: ***Observed***

Description of practice: Certain fundamental corporate decisions are the exclusive power of the shareholder meeting: changing registered office; authorizing capital increases; waiving pre-emptive rights; buying back shares; amending articles of association; delisting; acquisitions, disposals, mergers and takeovers; changes to company business or objectives; making loans and

[13] Approximately 35 percent of shares are in paper form. This percentage consists largely of the shares held by promoters.
[14] Depositories Act.
[15] DVP2 means gross settlement on the securities side and netting out on the money side. While the transfer of dematerialized shares takes two days, the listing rules provide for a maximum of two weeks. This is because of physical shares. Most companies have share transfer committees, which approve the transfer of physical shares and update the share register. Substantially all traded shares (about 99 percent) are dematerialized and traded through the depositories.
[16] There are twenty offices of Registrars of Companies under the Department of Company Affairs.
[17] Section 257 of the CA.
[18] Default in dividend payment may result in a three-year prison term and a fine of RS 1,000 (USD 22) for every day of default.

investments beyond limits prescribed under CA Section 372A; authorizing the board to: (i) sell or lease major assets;[19] (ii) borrow money in excess of paid-up capital and free reserves, and (iii) appoint sole selling agents and apply to the court for the winding up of the company. Such decisions require a 75 percent majority present and voting.

Policy recommendations: The provision dealing with the selling or leasing of major assets should be further refined to avoid any abuse.

Principle IC: Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general them. (i) Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting. (ii) Opportunity should be provided for shareholders to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations. (iii) Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

Assessment: ***Observed***

Description of practice: Under the CA, a company must hold an AGM every year. The notice must be sent to all shareholders 21 days in advance.[20] It must specify the meeting place and time and contain an agenda.[21] In case of special business,[22] the agenda must set out the material facts concerning each item, including the nature of the concern or interest of any director or manager.[23] The AGM must be held at or near the company's registered office.[24] Reportedly, some companies hold AGMs in remote locations, which discourages attendance. The standard quorum is five shareholders. If the quorum is not met after half an hour, the meeting is dissolved if called by shareholders, or postponed for one week if called by the board. Shareholders may vote in person or through proxies who have registered with the company up to 48 hours before the meeting.[25] The CA allows postal voting for certain fundamental decisions.[26] Any shareholder may apply to the Company Law Board (CLB) to call an AGM if the company has defaulted in conducting an AGM. The requisition for an EGM must be signed by shareholders holding at least 10 percent of the paid up voting capital. Resolutions of a meeting requisitioned by shareholders must be circulated in advance by them. The meeting must take place within 45 days. Shareholders can vote by show of hands or demand a poll, if they own at least 10 percent of voting rights.

Principle ID: Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

Assessment: ***Largely observed***

Description of practice: Nominee accounts are prohibited; accounts are held in the name of beneficial owners. There are two classes of shares: (i) ordinary shares, which carry one vote per share and are the only shares permitted for trading, and (ii) preference shares, which carry no voting rights. Shareholder agreements need not be disclosed to the company and other shareholders. Listing rules require share ownership to be declared on the basis of promoters, DFIs, foreign institutional investors (FII), mutual funds, foreign holdings, other corporate bodies,

[19]Section 293(1)(a) of the Companies Act, 1956.
[20]Section 171 of the Companies Act, 1956.
[21]Section 172 of the Companies Act 1956.
[22]Special business is defined under Section 189 of the Companies Act, 1956. In case of an AGM, any business other than the adoption of financial statements, declaration of dividends and appointment of directors and auditors is treated as special business. All business is treated as special business in case of other meetings.
[23]Section 173 of the Companies Act, 1956.
[24]Section 166 of the Companies Act 1956.
[25]Shareholder can appoint a proxy under Section 176 of the Companies Act. A proxy can demand a poll and cast his vote but cannot speak at the meeting. The notice convening the meeting must state that a shareholder can appoint a proxy.
[26]Such as alteration of the memorandum or articles of associations; buy-back of own shares by the company; change in place of Registered Office; sale of whole or substantially the whole of undertaking of a company. Source: Section 192A of the CA.

the top 50 shareholders, and other shareholders. FIIs must register with SEBI to participate in the market.[27] FIIs issue synthetic instruments called "participatory notes"[28] to investors who want indirect exposure to the Indian equity market. About 20 percent of the Foreign Institutional Investment is through participatory notes.[29] Investors crossing the 5 percent threshold must inform the stock exchange and SEBI. Issuers must disclose in their quarterly reports all investors who own 1 percent or more of their shares. This information is filed on Edifar, an Edgar-like system. However, the mandatory disclosure includes only the shareholder's name - not the address. This is often insufficient to identify an investor. While there is a trend towards more transparent share ownership, the classification still fails to give a fully transparent picture of control due to the prevalence of complex cross-holdings across family or business groups.

Policy recommendations: The legal framework and stock exchange rules should provide for full disclosure of shareholder agreements that could have an impact on how the company is governed or how other shareholders may be treated. For example, agreements include understandings with respect to the exercise of voting rights, puts and calls, rights of first refusal, and powers of certain shareholders to nominate corporate officers."

Principle IE: Markets for corporate control should be allowed to function in an efficient and transparent manner.

Assessment: ***Observed***

Description of practice: As India integrates into the global economy, critical mass, process efficiency and productivity are becoming important issues for firms. Consolidation is driving the market for corporate control. Transparency has increased since SEBI issued a takeover code in 1997. The code requires any person or body corporate whose shareholding crosses the 5 percent threshold to disclose it to the stock exchange and to SEBI; an acquirer who crosses the 15 percent threshold must make an offer for at least an extra 20 percent of the shares and deposit 25 percent of the value of his bid in an escrow account. The minimum price for this public offer cannot be lower than the negotiated acquisition price or the highest price paid by the acquirer during the last 26 weeks. Within a 12 month period, a maximum of 5 percent may be acquired without it being considered a "creeping acquisition." Poison pills are banned by law. The SEBI Takeover Code has been successfully tested in over 25 hostile bids.

Principle IF: Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

Assessment: ***Materially not observed***

Description of practice: Pension funds do not play a corporate governance role. The Unit Trust of India (UTI),[30] the Life Insurance Company (LIC) and the General Insurance Company (GIC) are the three largest institutional investors and are government owned. Together, they own 15-20 percent of the listed sector. These institutions seldom exercise their voting rights but exert influence through directors nominated to the board of their portfolio companies.

Policy recommendations: Regulators should consider introducing an obligation that institutional investors acting in a fiduciary capacity adopt and disclose their corporate governance and voting policy. They should also disclose to the public how they manage material conflicts of interest that may affect the exercise of their corporate governance rights. Shareholder activism among retail investors should be encouraged.

[27]The sub-accounts of FIIs can also register directly.
[28]These are mirror notes, which are linked to the performance of the Indian market but without direct participation in it.
[29]*Source:* National Stock Exchange.
[30]India's largest mutual fund.

Section II: The Equitable Treatment of Shareholders

Principle IIA: The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. All shareholders of the same class should be treated equally. (i) Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote. (ii) Votes should be cast by custodians or nominees in a manner agreed upon with the share's beneficial owner.

Assessment: ***Partially observed***

Description of practice: The CA[31] confers rights to shareholders in matters of oppression by the majority or mismanagement. The lesser of 100 shareholders or those representing 10 percent of shareholders can apply to the CLB for redress. CLB can instruct management to buy out dissenting shareholders, terminate or modify agreements entered into by the company or remove/appoint directors to the board. CLB's decisions may be appealed to the high and supreme courts. Any shareholder may apply for the winding up of a company. Investors can also apply to SEBI for redress. SEBI can disbar company directors and delist companies or pass a judicial order. Clause 49 requires issuers to set up a "Grievance Committee," chaired by a non-executive director, to look into the redress of shareholders rights and investor complaints.[32]

The courts authorize derivative actions in certain cases. Relief goes to the company. Class action suits have been initiated in mergers where shareholders were unsatisfied by the proposed share-swap ratio.[33] However, prolonged delays are the norm in court proceedings. Market analysts report that it is not unusual for the first hearing to take six years and the final decision up to 20 years.

Shareholders have the same voting rights within the same class. Information about the voting rights of each class is easy to obtain. Custodians do not usually have to consult beneficial owners on how to vote the underlying shares of ADRs. Most contracts give voting rights to management. Infosys is the exception – the ADR holders may instruct the custodian on how to vote.

Policy recommendations: Depository receipt contracts should provide owners with the same rights to vote as are accorded to holders of the underlying shares, in line with ICGN[34] recommendations. Policymakers should consider whether to strengthen the enforcement powers of regulators to offset the backlog and delays of court procedures.

Principle IIB: Insider trading and abusive self-dealing should be prohibited.

Assessment: ***Partially observed***

Description of practice: Insider trading is regulated by the SEBI (Prohibition of Insider Trading) Regulation, 1992, which criminalizes insider trading and abusive self-dealing. Anybody in possession of price sensitive information is considered an insider. Price sensitive information must be disclosed to the exchange promptly. In 1995, SEBI directed the stock exchanges to set up surveillance departments. Investor perception of market integrity seems to have improved since. However, implementation of the Regulation is problematic. Despite BSE's and NSE's electronic trading facilities and mutual exchange of information, it is difficult to flag a trade as a possible case of insider trading. A person with insider information can create fire-walls between himself and the regulators, given the number of intermediaries who operate in the market. Anecdotal evidence suggests that front running remains a problem. An additional factor making surveillance more difficult, are multiple listings. SEBI is in the process of setting up a unique

[31]Sections 397 and 398.
[32]Section VI (C), Clause 49 (2000).
[33]In some instances, the judges have seen merit in shareholder arguments and have ordered the companies to modify the ratio.
[34]International Corporate Governance Network.

client code (UCC) for each investor.[35]

Senior management must disclose to the board all material financial and commercial transactions, where they have personal interest and that may conflict with company interests.[36] Directors must disclose share dealings above a certain threshold to the exchanges and the same is disseminated as part of the Daily Bulletins. Directors, officers and designated employees must hold their shares for 30 days before they can trade them.

Policy recommendations: SEBI's initiative to provide each investor with a unique client code should be implemented. A greater level of cooperation between NSE and BSE on surveillance could further enhance the integrity of the market. The perception of market integrity will be enhanced, once an insider trading case has been successfully prosecuted.[37]

Principle IIC: Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

Assessment: ***Partially observed***
Description of practice: Management, board members and their close families are included in the definition of related parties. A related party must disclose the nature of his/her concern or interest to the board of directors. The audit committee reviews and approves all material related party transactions, materiality being defined by the committee.[38] Listed companies must disclose the information to shareholders under guidelines of the Institute of Chartered Accountants of India (ICAI). Reportedly, some firms obey the letter, not the spirit, of the law. One example is to restrict ownership in a company to 49.9 percent to avoid having to call it a "subsidiary." Misuse of corporate assets and abuse in related party transactions remain problems. It is not always easy to identify "related parties" or assess the fairness of a transfer price.

Policy recommendations: The disclosure protocol for related party transactions is a necessary, but insufficient condition to protect minority shareholders from potential abuse. While the audit committee should pre-vet related party transactions, the ultimate responsibility should remain with the board as a whole.

Section III: Role of Stakeholders in Corporate Governance

Principle IIIA: The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.

Assessment: ***Observed***
Description of practice: The corporate governance framework requires the board of directors to discuss material issues regarding employees and other stakeholders.[39] Secured creditors offering long term debt have the right to be represented on the board through "nominee directors."

Principle IIIB: Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

Assessment: ***Partially observed***
Description of practice: Creditors can petition the CLB, Board for Industrial and Financial Reconstruction (BIFR, the special bankruptcy court under SICA), civil and high courts, as well

[35]The UCC in effect now is not "unique" in the sense that the same person can have various UCCs.
[36]Section V (B), Clause 49 (2000).
[37]*See* Annex D, "The Insider Dealing Investigation of Samir Arora."
[38]Section II (D)(c), Clause 49 (2000).
[39]See also Principle VC.

as the Debt Recovery Tribunals for violation of their rights. Employees and environmental groups can seek redress through the civil and high courts. However, there are long delays and backlogs. Creditors seldom approach the courts when their rights have been violated, except by recalling their loans and initiating recovery procedures. Civil courts discourage creditors from litigating on issues relating to governance, citing "indoor management" policy.

Policy recommendations: Please refer to the forthcoming Insolvency/Creditors Rights ROSC.

Principle IIIC. The corporate governance framework should permit performance-enhancement mechanisms for stakeholder participation.

Assessment: ***Observed***
Description of practice: SEBI has issued detailed guidelines on share options. Promoters are not eligible for stock options. Share option schemes are approved at the AGM. Stock options are not expensed in the income statement, but disclosed in the notes.[40] There is no ceiling on how many stock options can be issued. The options are tied to specific performance goals and vested over a time period - typically three to six years. Large grants (exceeding 1 percent of capital) must be individually voted on by special resolution.

Policy recommendations: Closely follow the international debate on good practices regarding the treatment of stock options.

Principle IIID: Where stakeholders participate in the corporate governance process, they should have access to relevant information.

Assessment: ***Observed***
Description of practice: Information is posted on the company and stock exchange websites. According to market analysts, the quality of the information varies markedly between the first two hundred listed companies and the rest of the market.

Section IV: Disclosure and Transparency

Principle IVA: The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and the governance of the company. Disclosure should include, but not be limited to, material information on: (1) The financial and operating results of the company. (2) Company objectives. (3) Major share ownership and voting rights. (4) Members of the board and key executives, and their remuneration. (5) Material foreseeable risk factors. (6) Material issues regarding employees and other stakeholders. (7) Governance structures and policies.

Assessment: ***Largely observed***
Description of practice: (1): Companies must prepare and send an annual report to shareholders, the stock exchange, DCA, and ROC. Its content is regulated by statute. It includes a chairman's statement (non-mandatory), management discussion and analysis (MD&A), directors' report, balance sheet, profit and loss account, notes, discussion of significant accounting policies, auditor opinion, segment accounts, and a cash flow statement. Consolidation is mandatory for listed companies and financial institutions. (2): Commercial company objectives and policies related to business ethics are not disclosed in the MD&A. (3): Share ownership must be disclosed in the annual report by investor category (promoters, financial institutions, foreign investors, etc.) and by tranches of ownership (up to 500 shares, 501 to 1000, etc.). Disclosure does not extend to the level of ultimate beneficiary and the structure of business groups. (4): The annual report's corporate governance section includes summary information on directors, including qualifications, relationship with each other and management, attendance records, number of directorships held (and in which companies). Sitting fees and commissions (for non-executive directors), bonuses, salaries, stock options and loans (for executive directors) must be

[40] The SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines (1999) provide an option to either follow the 'intrinsic value method' or the 'fair value method' and expense could appear in certain situations.

disclosed individually and in aggregate. Senior management salaries and bonuses are reported individually.[41] (5): Company policies on risk management and material risk factors are disclosed in the annual report. It includes a discussion on internal controls, accompanied by a director responsibility statement. (6): Section 217 of the CA requires the board to report annually on employee and other stakeholder issues. (7): The annual report contains a section on corporate governance, certified by the auditor.[42] Market analysts confirm that the quality of disclosure has improved in recent years, as companies begin to understand the relationship between transparency and market valuation. However, the stock exchanges' human resources[43] are insufficient to ensure compliance. Consequently, they heavily rely on the auditors.

Policy recommendations: SEBI and the exchanges need to cooperate more closely to effectively monitor and enforce compliance with the listing agreement. It is imperative that steps are taken to clarify the division of responsibilities among stock exchanges, SEBI and DCA to avoid unintentional regulatory overlap and potential conflicts.

Principle IVB: Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

Assessment: ***Largely observed***

Description of practice: The quality of financial disclosure for listed companies is determined by the DCA, SEBI, and ICAI. ICAI lays down the parameters of accounting and auditing standards. According to ICAI, India is materially in conformity with International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA). Under the CA, management must explain any deviations from the prescribed accounting standards in the financial statements. The sanctions for non-compliance with financial disclosures range from a maximum fine of Rs 2,000 (USD 44) to imprisonment of up to six months.[44] In practice, there have been no instances of imprisonment. Usually, if a company does not comply with proper audit practices or does not make available the necessary financial documents, the penalty is a maximum fine of Rs 500 (USD 11). Qualified auditor opinions do not prompt automatic action from SEBI. However, companies must disclose the qualification in each quarterly report. If the auditor's signed reports do not conform with the law, the maximum penalty is Rs 10,000 (USD 220). Moreover, judicial delays diminish the deterrence-factor of such penalties. ICAI can take disciplinary actions against its members.

Policy recommendations: Please see Accounting and Auditing ROSC for an assessment of the strengths/weaknesses of the institutional framework for supporting high quality accounting and auditing practices. Fines should be significantly enhanced to act as credible deterrents.

Principle IVC: An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.

Assessment: ***Partially observed***

Description of practice: The CA requires annual accounts to be audited by a certified chartered accountant who is an ICAI member. Quarterly reports are subject to a limited audit review. Auditors must also issue an annual certification that Clause 49 has been complied with. Auditors are appointed at the AGM. Auditor independence is defined under Section 226 of the CA.

[41] Section 217 of the CA and Section III (B) of Clause 49 (2000).
[42] Section VII of Clause 49 (2000).
[43] For example, BSE's department of corporate services consists of 29 people, who monitor the listing agreements of 5,700 companies, as well as initial listing. NSE has less than 20 people.
[44] The forthcoming Securities Law Amendment Bill is expected to increase penalties substantially.

Accordingly, a person is ineligible for appointment if s/he is a body corporate; an officer or employee of the company; a partner or in the employment of an officer or employee of the company; a person indebted to the company for an amount over Rs 1,000 (USD 22) or who has given any guarantee or security; or a person holding voting shares of the company. There is no mandatory auditor rotation.[45] Auditors are permitted to render consulting services to the company they audit up to the level of the audit fee, subject to the audit committee's approval.[46] Those fees are disclosed separately in the annual report. ICAI's functions include conducting entrance examinations, granting certificates of practice, providing education, conducting peer reviews and ensuring adherence to general, technical and ethical standards.[47] With respect to the creation of an independent oversight board for the audit profession, ICAI's position is that independence is assured, given that six out of 30 board members are nominated by the government. As the Naresh Chandra Committee Report cites, there have been concerns over the length of disciplinary proceedings. That report goes on to say that "such delays must be avoided… (and) that the confidence of the investing public, especially small investors, cannot be nurtured unless disciplinary cases are dealt with more expeditiously and transparently."[48]

Policy recommendations: The recommendations of the Naresh Chandra Committee on Corporate Audit and Governance[49] regarding non-audit services to audit clients, rotation of auditors and qualified audit opinions are included in the current Companies (Amendment) Bill. It is important that this legislation go forward. In order to enhance the quality of auditing practice, policymakers should consider options to establish a monitoring and enforcement arrangement in line with recent international developments and the recommendations of the Naresh Chandra Committee.

Principle IVD: Channels for disseminating information should provide for fair, timely, and cost-effective access to relevant information by users.

Assessment: ***Observed***

Description of practice: Dissemination channels include direct mailing, company websites, the stock exchange, and press announcements. Price sensitive information must be disclosed to the exchange continuously. This is published online by the exchanges. The major cost for issuers is the printing and distribution of the annual report to each shareholder. For companies with many shareholders, the expense is significant. Moreover, although consolidation is now mandated for listed companies, Section 212 of the CA still requires publication of accounts of all subsidiaries. This makes the annual report bulky and adds to distribution costs.

Policy recommendations: Offer shareholders the option to decline to receive the full annual report and receive a summary instead, the content of which would be regulated by SEBI.

Section V: The Responsibility of the Board

Principle VA: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

Assessment: ***Largely observed***

[45] There are approximately 43,000 audit firms in India, 75 percent of which are single person proprietary firms.
[46] Section II (D)(b), Clause 49 (2000).
[47] In 2002, ICAI's membership exceeded 100,000; over 70,000 held certificates of practice. The public practice is carried out by members as individuals of partnership firms.
[48] Naresh Chandra Committee Report on Corporate Audit and Governance, 3.21. Reportedly, a bill has been introduced in Parliament as one of several steps to make the process more expeditious and transparent.
[49] Established in August 2002 by DCA to examine various corporate governance issues.

Description of practice: Indian firms have a unitary board structure. The board is accountable to shareholders. It ensures the strategic guidance of the company and monitors management. The members of the board of directors are considered to hold the fiduciary position of a trustee for the company. The basic fiduciary duties are not spelled out in legislation, but are embedded in the jurisprudence, which remains sparse. It is not customary for directors to be covered by an insurance policy. Traditionally, companies have been dominated by their promoters, who act as managers, and not by their boards. While the board has the general power of stewardship, it can delegate certain powers to employees who are on the board, i.e. "whole time" or "executive directors." The CA defines the concept of "officer in default" for contraventions committed by a company.[50] These are: (i) the managing director(s); (ii) executive or whole-time director(s); (iii) manager(s); (iv) the company secretary; (v) any person in accordance with whose instructions the board acts; and (vi) any person who has been charged by the board to be an officer in default, subject to his/her consent.[51] However, the "officer in default" concept has been interpreted by some to mean that there are different levels of fiduciary liability for different kinds of directors – the executive director being the first in line and the independent director being the least liable. The introduction of the audit committee added a new layer to the set: audit committee members are considered by some "more liable" than the rest of the board.

Policy recommendations: The CA should clearly spell out the fiduciary obligations of directors, including care, skill and diligence in the performance of their duties, as well as loyalty and avoidance of conflicts of interest. There should not be different standards of care for executive and independent directors, except where executive directors act in a management function that has been clearly delegated by the board and that is separated from the board functions. Directors should have access to training in order to fully understand their rights, responsibilities, duties and liabilities.

Principle VB: Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

Assessment: ***Largely observed***

Description of practice: Board members have a fiduciary obligation to treat all shareholders fairly. If shareholders feel treated unfairly, they have the right of appeal to SEBI, Court and the Company Law Board.

At least two-thirds of the board of directors should be rotational.[52] One-third consists of permanent directors, which include promoters, executive directors and nominee directors.[53] Section IA, Clause 49, requires issuers to have at least one-third independent directors, if the functions of chairman of the board and CEO are decoupled, and 50 percent otherwise.[54] An independent director is defined as a non-executive director who, *inter alia,* has no material pecuniary relationships or transactions with the company, its promoters, senior management or its holding company, its subsidiaries and associated companies, which in the judgment of the board may affect the independence of judgment of the director,[…] and is not related to promoters or management at the board level, or at one level below the board. Reportedly, there

[50]Sections 2(31) and 5 of the CA.

[51]There is some concern that criminal liabilities on account of technical infringement of other laws committed by management could fall upon independent directors. The roles of management and the board need to be clearly separated to resolve this issue.

[52]Section 255 of the CA. Of these, one-third retires every year and is eligible for reappointment.

[53]Almost all major listed companies with a sizeable debt from banks, DFIs and insurance companies, have nominee directors. Section I (A), Clause 49 (2000) requires these directors to be elected by shareholders like any other director.

[54]It is not common practice for the positions of chairman and CEO to be held by the same person. Section I (A), Clause 49 (2000).

are cases where so-called "independent" directors are, in reality, former employees, relatives, lawyers, consultants, employees of associated companies, etc.

Policy recommendations: It has been argued that the institutional nominee directors representing DFIs do not bring specialized knowledge and hence, contribute little to the deliberation of the boards. An alternative would be for DFIs to nominate expert independent directors on their behalf. This would make them more independent. Such directors would not face the same conflicts of interest in situations where the repayment of loans is discussed as do current and former DFI employees. The maximum term of independent directors should be capped.

Principle VC: The board should ensure compliance with applicable law and take into account the interests of stakeholders.

Assessment: ***Observed***

Description of practice: The company secretary ensures that the board complies with its statutory duties and obligations. The board reports annually on company activities,[55] including company performance on environmental issues, labor issues, tax compliance and provisions of the Competition Act.

Principle VD: The board should fulfill certain key functions, including (1) 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. (2) Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning. (3) Reviewing key executive and board remunerations, and ensuring a formal and transparent board nomination process. (4) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions. (5) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law. (6) Monitoring the effectiveness of the governance practices under which it operates and making changes as needed. (7) Overseeing the process of disclosure and communications.

Assessment: ***Largely observed***

Description of practice: (1): All the functions set out in sub-Principle (1) above are the responsibilities of the board of directors. Most large listed companies comply with them in letter and spirit. However, some smaller companies reportedly treat these functions as a "box ticking" exercise. (2): It is the board's responsibility to appoint senior management. (3): Large companies usually have remuneration committees, which evaluate the performance and compensation of executive directors and senior management. The listing rules require that the compensation of non-executive directors be fixed by the board.[56] The CEO's emoluments are usually determined by the remuneration committee and subject to shareholder approval. The CA vests the power to appoint directors with the shareholders and prescribes the process of how the board should be renewed.[57] (4): The audit committee reviews related party transactions with promoters or management, their subsidiaries or relatives, etc. If any transaction is not on an arm's length basis, management must provide an explanation to the audit committee justifying it.[58] (5): The board is responsible for signing off on the company's balance sheet and profit and loss statement, ensuring that these documents are filed with the registrar and sent to shareholders. (6): The annual report contains a section on corporate governance with certification of the company secretary and auditor. One of the audit committee's functions is to ensure compliance with governance practices. (7): There is no rule vesting the responsibility of overseeing the process of disclosure and communication with the board.

[55]Section 217 of the CA.
[56]Section III (A) of Clause 49 (2000).
[57]Sections 252 to 284 of the CA.
[58]Section II (D)(c) of Clause 49 (2000).

Policy recommendations: Clearly-defined board procedures are needed to allow the board to effectively exercise its oversight function on risk management. International good practice suggests that shareholders should be consulted with respect to the general compensation policy for senior management, rather than each individual compensation package. The department in charge of corporate communication should have a direct reporting line to the board.

Principle VE: The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management: (1) boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination, and executive and board remuneration. (2) board members should devote sufficient time to their responsibilities.

Assessment: ***Partially observed***

Description of practice: (1): Audit, nomination and remuneration/compensation committees are common.[59] The audit committee should have at least three members, all non-executive, with a majority being independent and at least one director having financial and accounting expertise.[60] Its chairman should be independent. The audit committee's role, composition, functions, powers and attendance requirements are detailed in Clause 49 (2000), Section II.[61] The audit committee's recommendations are binding on the board. Reportedly, in some companies, audit committee meetings take place hurriedly before the full board meeting. (2): A director may be a member of up to 15 company boards.[62] Clause 49 (2000) caps the number of committee chairmanships to five and the number of committee memberships to ten.[63] Independent director compensation has two components: a small sitting fee and a commission of up to 1 percent of net profits. Loss-making companies, banks and public sector companies cannot pay commissions except with the express authorization of the pertinent regulatory authority.

Policy recommendations: Given that multiple board memberships held by the same person can interfere with the performance of directors, companies and shareholders should consider whether such a situation is desirable. Audit committee members have sufficient financial and accounting knowledge to understand financial information, ask informed questions to the internal and external auditors and conduct meaningful meetings. Special training courses should be developed, including possibly a certification program. Adequate across-the-board compensation for independent directors will help ensure that they devote sufficient time to their responsibilities and will increase the supply of high quality candidates. Compliance with the audit committee requirements should be monitored closely by regulators.

Principle VF: In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

Assessment: ***Observed***

Description of practice: In the past, management has shared little substantive information with outside directors, who were often selected with the tacit understanding that they would not ask for such information. Clause 49 (2000) mandates the information that must be placed before the board. This information is sufficient to inform directors about the financial and non-financial situation of the firm. Non-executive and independent board members also have access to expert advice at company expense. The audit committee has the right to: (i) investigate any activity within its terms of reference; (ii) seek information from any employee; (iii) obtain outside legal

[59] Only audit committees are mandated by law.

[60] Section II (A)(a) of Clause 49 (2000).

[62] Sections 277 and 278 of the CA.

or other professional advice, and (iv) secure attendance of outsiders with relevant expertise.[64]

III. SUMMARY OF POLICY RECOMMENDATIONS

This section sets out recommendations to improve listed companies' compliance with the OECD Principles. Annex B details the above policy recommendations. The next step is the development of a detailed action plan, formulated in cooperation with the authorities and in consultation with the private sector and other stakeholders. Several key themes can be prioritized as follows:

1. **Sanctions and enforcement**: While the CA provides for sanctions for corporate governance violations, sometimes these are inadequate and should be adjusted. This is especially true for monetary sanctions. However, the new fining powers to be given to SEBI and enhanced sanctions to be introduced for contraventions to the listing agreement combined with more effective cooperation between SEBI and the exchanges should enable stronger sanctions to be undertaken. As regards the enforcing of the sanctions, the amended SEBI Act gives it certain pre-emptive powers, such as attachment of bank accounts. In order for fines to be appealed to the Securities Appellate Tribunal and the Supreme Court, they should have to be paid at least in part. Pre-emptive provisions could also be introduced in the CA.

   Stock exchange sanctions include warnings, trading suspension, de-listing, but no fines. Stock exchanges should be able to impose fines on market intermediaries that are high enough to act as credible deterrents. The exchanges could also publish warnings and censures/reprimands in the newspaper. Another issue for policymakers is de-listing procedures. About 3,000 companies are either totally illiquid and/or in breach of the listing rules.[65] An efficient mechanism is needed to allow minority shareholders to exit from such investments at a fair price. *Priority:* ***high***

2. **Regulatory arbitrage:** The DCA, SEBI and the stock exchanges share jurisdiction over listed companies. This creates a potential for regulatory arbitrage and weakens enforcement. An in-depth revision of the three-tiered regulatory system would reveal whether changes in the respective roles and responsibilities of the involved institutions and their supervisory functions are in order. Clarification of responsibilities could strengthen enforcement and reduce the danger that issuers treat compliance as a "box ticking" exercise. It is important to keep in mind the enormous size of the equity market and the implications of any changes in the respective organizational structures and capacities. *Priority:* ***medium***

3. **The creation of a credible director training institution.** If boards are to move away from simply "rubber stamping" the decisions of management or promoters, they must have a clear understanding of what is expected. They should know their duties of care and loyalty to the company and all shareholders. The law or other regulations should spell out the responsibilities of directors and they themselves should engage in the formulation of their tasks and work procedures. A key missing ingredient is a strong focus on director professionalism. Director training institutes can play a key capacity building role and expand the pool of competent candidates. *Priority:* ***high***

4. **Institutional investors.** Institutional investors could become important forces to monitor insiders and play a disciplining role in the governance of corporations. The behavior of

[64] Section II (C) of Clause 49 (2000).

[65] SEBI issued Delisting Guidelines in 2003. Steps are being taken by BSE to delist 97 companies whose securities have been suspended from trading for more than five years.

institutional investors has traditionally been characterized by apathy with respect to voting – they prefer to use "exit" over "voice" to express dissatisfaction with a company. In addition, asset managers owned by financial institutions that maintain credit and advisory relationships with portfolio companies tend to feel uncomfortable when exercising their voting rights, especially against management. Policymakers could play a role in encouraging institutional investors who act as fiduciaries to attend shareholder meetings and vote. This might encourage shareholder activism across the board, which is an important engine of change in corporate governance reform. Increasingly, international good practice suggests that it is preferable for institutional investors to nominate independent directors to the boards of their portfolio companies, rather than awarding the position to current or retired employees who may offer little value added and are more likely to be subject to conflicts of interest in the exercise of their fiduciary duties. *Priority:* ***medium***

Annex A: Summary of Observance of OECD Corporate Governance Principles

PRINCIPLE		O	LO	PO	MO	NO	Comment
I. THE RIGHTS OF SHAREHOLDERS							
IA	Basic shareholder rights	X					• Shares traded through a stock exchange are held in dematerialized form in the two depositories: National Securities Depository and Central Depository Services. • Registration in a depository is proof of ownership. • Companies must maintain a register of shareholders or outsource this function to a share transfer agent. • Shares traded through stock exchanges are transferred through book entry at the depositories. • Cash settlement occurs at designated clearing banks of stock exchange clearing houses. Clearance/settlement occurs in DVP2 on T+2. • Novation exists at National Stock Exchange (NSE), but not Stock Exchange, Mumbai (BSE). • Guarantee funds have largely eliminated settlement risk. Central Bank plans to introduce real time gross settlement in 2004. • Annual and half yearly accounts are mailed to shareholders; quarterly accounts are published in newspapers and posted on web pages of issuers and stock exchanges. • Companies must file memorandum, articles of association and periodic financial information with a Registrar of Companies (ROC). Investors can access this information for nominal fee (about USD 1). • Usually, directors are proposed by board and elected by shareholders. Shareholders can propose candidates up to fourteen days before AGM, but shareholders seldom use this right. • Board proposes dividend, and AGM approves it.

IB	Rights to participate in fundamental decisions.	X					• Certain fundamental corporate decisions are the exclusive power of AGM and require 75 percent majority:
							  • changing registered office;
							  • authorizing capital increases;
							  • waiving pre-emptive rights; buying back shares;
							  • amending articles of association;
							  • delisting;
							  • acquisitions, disposals, mergers and takeovers;
							  • changes to company business or objectives;
							  • making loans and investments beyond limits prescribed under CA Section 372A,
							  • authorizing board to: (i) sell or lease major assets; (ii) borrow money in excess of paid-up capital and free reserves, and (iii) appoint sole selling agents and apply to the court for the winding up of company.

IC	Shareholders' AGM rights	X					• AGM mandatory, according to Companies Act (CA). • 21 day AGM notice (meeting place, time, agenda) sent to all shareholders. • In case of special business, agenda must set out material facts, including nature of concern or interest of any director or manager. • Some companies reportedly hold AGMs in remote locations. • Quorum is five shareholders. If quorum is not met after half an hour, meeting is dissolved if called by shareholders, or postponed for one week if called by board. • Shareholders may vote in person or proxy. • CA allows postal voting for fundamental situations. • Any shareholder may apply to Company Law Board (CLB) to call AGM. • Shareholders with 10 percent of paid-up voting capital can call EGM. • Shareholders can vote by show of hands or demand poll, if they own at least 10 percent of voting rights.
ID	Disproportionate control disclosure		X				• No nominee accounts. • Shareholder agreements need not be disclosed to company/ shareholders. • Prevalence of complex cross-holdings across family or business groups still fails to provide a fully transparent picture for shareholders.
IE	Markets for corporate control should be allowed to function.	X					• SEBI Takeover Code has been successfully tested in 25 + hostile bids. • Takeover Code requires anyone whose holdings cross 15 percent threshold to make offer for at least 20 percent more of shares.

	PRINCIPLE	O	LO	PO	MO	NO	Comment
IF	Cost/benefit to voting				X		• Pension funds seldom exercise voting rights, instead exert influence through nominee directors on the board of their portfolio companies.
	II. EQUITABLE TREATMENT OF SHAREHOLDERS						
IIA	All shareholders should be treated equally			X			• Shareholders can apply the CLB, SEBI or the company "Grievance Committee" for redress. Derivative and class action suits exist. • Doubts persist about the effectiveness of legal remedies in practice.
IIB	Prohibit insider trading			X			• Insider trading is a criminal offense, but enforcement is problematic. • Senior management must disclose to board potential conflicts of interest. • Directors must disclose share dealings beyond certain threshold.
IIC	Board/Mgrs. disclose interests			X			• Reportedly, misuse of corporate assets and abuse in related party transactions remain problems.
	III. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE						
IIIA	Stakeholder rights respected	X					• Board is required to discuss material issues regarding stakeholders.
IIIB	Redress for violation of rights			X			• Redress can be sought through civil and high courts; however, there are long delays and backlogs.
IIIC	Performance enhancement	X					• SEBI has issued detailed guidelines on the issue of stock options.
IIID	Access to information	X					• Relevant information is posted on company and stock exchange websites, but quality of info varies among companies.
	IV. DISCLOSURE AND TRANSPARENCY						
IVA	Disclosure standards		X				• Companies must send annual report to shareholders, stock exchanges, DCA and ROC; content regulated by statute. • Disclosure does not extend to level of ultimate beneficiary and structure of business groups. • Quality of financial reporting improving, but stock exchanges lack sufficient resources to ensure compliance and rely heavily on auditors.
IVB	Standards of accounting & audit		X				• Quality of financial disclosure determined by DCA, SEBI and ICAI. • ICAI says India conforms with ISA. • Judicial delays diminish deterrence factor of some penalties.
IVC	Independent audit annually			X			• Auditors can provide consulting services to the company they audit up to the level of the audit fee, and fees disclosed in the annual report. • Disciplinary proceedings can be lengthy.
IVD	Fair & timely dissemination	X					• Dissemination channels include direct mailing, company websites, the stock exchange, and press announcements. • Printing/distribution of annual report to all shareholders and necessity of publishing accounts of all subsidiaries add greatly to issuer costs.
	V. RESPONSIBILITIES OF THE BOARD						
VA	Acts with due diligence, care		X				• Unitary board structure. • Basic fiduciary duties are not spelled out in legislation, but embedded in sparse existing jurisprudence.
VB	Treat all shareholders fairly		X				• Board members have a fiduciary obligation to treat shareholders fairly. • Shareholders can appeal to SEBI or the courts • At least 2/3 of board rotational.
VC	Ensure compliance w/ law	X					• The company secretary ensures the board complies with its statutory duties and obligations.
VD	The board should fulfill certain key functions		X				• There is no rule vesting the responsibility of overseeing the process of disclosure and communication with the board. • Small companies practice "box-ticking."
VE	The board should be able to exercise objective judgment			X			• Audit and remuneration committees are common. • Audit committee has three members, all non-executive and a majority of them independent. • Director may have membership on 15 boards and ten committees and may chair five committees.
VF	Access to information	X					• Clause 49 mandates information to be placed before the board; it is sufficient to inform directors about firm's financial/non-financial situation.

Annex B: Summary of Policy Recommendations

I. THE RIGHTS OF SHAREHOLDERS		
IA	Basic shareholder rights	• NA
IB	Rights to participate in fundamental decisions.	• The provision dealing with the selling or leasing of major assets should be further refined to avoid any abuse.
IC	Shareholders AGM rights	• NA
ID	Disproportionate control disclosure	• Shareholder agreements should be disclosed.
IE	Control arrangements should be allowed to function.	• NA
IF	Cost/benefit to voting	• Regulators should consider introducing an obligation that institutional investors acting in a fiduciary capacity adopt and disclose their corporate governance and voting policy. • Regulators should also disclose to the public how they manage material conflicts of interest that may affect the exercise of their corporate governance rights. • Shareholder activism among retail investors should be encouraged.
II. EQUITABLE TREATMENT OF SHAREHOLDERS		
IIA	All shareholders should be treated equally	• Depository receipt contracts should provide owners with same rights to vote as to vote as are accorded to holders of underlying shares. • Consider strengthening regulators' enforcement power to offset backlog and delays of court procedures.
IIB	Prohibit insider trading	• Implement SEBI's initiative of a unique client code for each investor. • There should be greater cooperation between NSE and BSE on surveillance. • Publish share trading by directors and senior management in the newspaper. • Successfully prosecute one insider trading case to enhance perception of market integrity.
IIC	Board/Mgrs. disclose interests	• While audit committees should pre-vet related party transactions, ultimate responsibility of judging whether a related party transaction is in the best interest of the company should remain with the board.
III. ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE		
IIIA	Stakeholder rights respected	• NA
IIIB	Redress for violation of rights	• Refer to Insolvency and Creditor Rights ROSC.
IIIC	Performance enhancement	• Closely follow the international debate on good practices regarding the treatment of stock options.
IIID	Access to information	• NA
IV. DISCLOSURE AND TRANSPARENCY		
IVA	Disclosure standards	• SEBI and stock exchanges need to cooperate more closely to effectively monitor and enforce compliance with listing agreement. • Steps must be taken to clarify division of responsibilities among stock exchanges, SEBI and DCA to avoid unintentional regulatory overlap and potential conflicts.
IVB	Standards of accounting & audit	• See Accounting and Auditing ROSC. • Significantly enhance fines to act as credible deterrents.
IVC	Independent audit annually	• Recommendations of Naresh Chandra Committee on Corporate Audit and Governance are included in pending legislation, which should go forward. • Consider different options to subject auditors to an auditor oversight body that operates in the public interest and that is not under the control of the auditing profession.
IVD	Fair & timely dissemination	• Give shareholders option to decline full annual report in lieu of summary, whose content would be regulated by SEBI.
V. RESPONSIBILITIES OF THE BOARD		
VA	Acts with due diligence, care	• The fiduciary obligations should be clearly spelled out in the legal or regulatory framework. • Have same standards of care for executive and independent directors, with few exceptions. • Provide directors with access to training.
VB	Treat all shareholders fairly	• Have DFIs nominate expert independent directors on their behalf. • Maximum term of independent directors should be capped..
VC	Ensure compliance w/ law	• NA
VD	The board should fulfill certain key functions	• Consider consulting shareholders with regard to general compensation policy for senior management, rather than individual packages. • The department in charge of corporate communication should have a direct reporting line to the board. • Clearly-defined board procedures are needed to allow board to effectively exercise its oversight function on risk management.
VE	The board should be able to exercise objective judgment	• Given that multiple board memberships by one person can interfere with performance of directors, companies and shareholders should consider desirability of such a situation. • Consider special training and certification program for audit committee members.

	• Adequate across-the-board compensation for independent directors will help increase supply of high quality candidates and ensure sufficient time is devoted to their responsibilities. • Compliance with the audit committee requirement should be monitored closely by regulators.
VF Access to information	• NA

Annex C: Enforcement of Shareholder Rights

I. Enforcement under the Companies Act

The Company Law Board, a quasi-judicial authority, (now replaced by the National Company Law Tribunal) is the enforcement arm under the Companies Act (CA)[66]. Enforcement matters referred to the CLB range from violation of procedure in change of main objects clause of the Memorandum of Association of the company to oppression and mismanagement of the company. Table 1 provides the enforcement statistics of the cases heard before the CLB between 1997 and 2001. The orders of the CLB, depending on the nature of the offense, can be appealed (anecdotal evidence suggests that most of the rulings are appealed) to the Company Courts or to the High Court, which are burdened with a large number of cases. Courts in India are seen as time-consuming, uncertain and costly to use due to the huge delays in rulings. The number of criminal prosecutions involving imprisonment for offenses under the CA are negligible.

Table1: Enforcement statistics of the Company Law Board (1997-2001)

Year	Cases pending at the beginning of the year	Cases received during the year	Cases Disposed during the year @	Cases Pending at the end of the year
1997-98	2798	29991	19033	13756
1998-99	13756	55903	50642	19016
1999-00	19016	62313	66926	14403
2000-01*	14403	20581	24053	10931

Source: Company Law Board Website www.clb.nic.in.

* data after this date is not available in the public domain.
@ withdrawal of cases of complainants also form part of this figure

The Naresh Chandra Committee on Corporate Governance Issues, set up by the Department of Company Affairs (DCA) in 2002, has made some observations regarding the need to improve the effectiveness of the enforcement procedures under the Companies Act. The report has made recommendations pertaining to rationalization of the penalties imposed under the CA, so that these are in proportion to the sums involved in the offense.[67] [68] Another recommendation pertains to the need to strengthen the investigation and prosecution wing of the DCA, creating a 'Serious Frauds Office' along the lines of the Serious Fraud Office (SFO) in the United Kingdom and streamlining the procedures in the CA so that these are effective and not cumbersome or time consuming. Yet another recommendation pertains to the need to ensure that proceeds from illegal acts and frauds do not escape recovery and so the Companies Act needs to be amended to give DCA the powers of attachment of bank accounts etc., on the lines of the powers recently given to SEBI. While the Corporate Serious Frauds Office has been set up last year, several other recommendations made by various committees to amend the Companies Act are yet to be carried out and form part of the pending legislation.

[66] Some of the sections under which the CLB has enforcement powers are 17, 18/19, 45 QA of RBI Act, 58A(9), 79/80A, 113, 118, 141,144, 163167, 186, 196, 219, 304, 307, 614, 621A, 111, 269(7), 634A, 22A (SCRA), 235, 237, 247/248, 250, 397/398, 408, 409.

[67] "Section 77 of the Companies Act places restrictions on the purchase by a company of its own shares or that of its holding company. Companies often indulge in such practice only to exaggerate their volume of trading, and to drive up its share prices. This amounts to misleading the various stakeholders, a case of corporate mis-governance, if not downright fraud. And yet the maximum penalty prescribed in this area is only Rs. 10,000/"*Source-Naresh Chandra Committee Report on Corporate Governance.*

[68] This observation has also been made by Joint Parliamentary Committee set to investigate the stock market scam in its report in December 2002.

II. Enforcement under securities laws

Investor protection and regulation of the securities market is one of the key mandates for the securities market regulator, SEBI[69]. SEBI enforces market regulation and investor protection related to its jurisdiction by drawing from this mandate and related legislations like the SEBI Act, 1992, Securities Contracts (Regulation)Act, 1956 and from the delegated provisions of the CA.[70]

SEBI has powers to carry out routine inspections of market intermediaries to ensure compliance with prescribed standards. It also has investigation powers similar to that of a civil court, in terms of being able to summon persons and obtain information relevant to its enquiry. The enforcement powers of SEBI include issuance of directions, imposition of monetary penalties, cancellation of registration and even prosecution of market intermediaries. SEBI enforces the legislation on insider trading in securities and fraudulent and unfair trade practices in the securities market.[71]

Following the recommendations of the Joint Parliamentary Committee set up to investigate the stock market scam of 2001, SEBI received a range of powers that have bridged many gaps found earlier in its enforcement powers - particularly in the area of investigation. Some of the powers include: search and seizure of documents for evidence; power to inspect the books of issuer companies; to stop the issue where there are reasonable grounds to believe there has been an insider trading violation; and the power to issue summons for the examination of witnesses and documents. Apart from the above, an amendment to the Securities Contracts (Regulation) Act, 1956 to give stiff penal powers to SEBI against listed companies for violating provisions of the listing agreement and to empower stock exchanges with de-listing powers is pending in Parliament. The new powers entrusted with SEBI are recent, and these have not been tested fully for effectiveness, nonetheless, the powers appear to have improved the number of prosecutions initiated by SEBI (338 between 2001 and 2003); that number surpasses the number of prosecutions initiated in the last ten years (83 between 1992 and 2001) by SEBI, particularly with regard to unfair trade practices and insider trading. The number of prosecutions successfully completed, however, is still small.

Selected issues in enforcement

Enforcement of Listing Agreement

The terms of the listing agreement govern the arrangements between listed companies and the stock exchanges in India. The enforcement of the listing agreement has certain gaps in compliance and monitoring. This arises mainly due to limitations in clear authority of SEBI to monitor and enforce the listing agreement directly. Moreover the stock exchanges, which carry out the day-to-day monitoring, are constrained by lack of effective sanctions for non-compliance. While the exchanges have the responsibility to enforce the listing agreement, they do not have the powers, remedies and resources to enforce it effectively (i.e. they do not have the power to impose fines on companies, their management or promoters, nor can they investigate cases of serious non-compliance). Even if SEBI were to prosecute companies for

[69] The Preamble of the SEBI Act provides the following as its main objective *"An Act to provide for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto."*

[70] Provisions contained in Sections 55 to 58, 59 to 84, 108, 109, 110,112, 113, 116, 117, 118, 119, 120, 121, 122, 206, 206A and 207 of the Companies Act have been delegated to SEBI in respect of listed companies or companies proposing to list. These sections cover provisions relating to issue and transfer of securities and non payment of dividend. This is only an indicative list of provisions delegated to SEBI.

[71] Report of the RBI Advisory Group on Securities Market Regulation, 2000.

violations of the listing agreement under its present authority, the enforcement process is time-consuming and cumbersome. Also, since this has not been tested before, legal professionals feel cases could be ruled against SEBI for want of clear jurisdiction over listed companies. The other sanctions available against non-compliant companies are delisting or suspending trading of a stock from the exchange; however, these measures affect the interests of shareholders and have been found to be largely ineffective in disciplining companies in the past. Close to 2,650 stocks on the Stock Exchange, Mumbai (BSE) have been identified as non-compliant with the listing agreement; however, no significant action against these companies has been taken so far. As mentioned earlier, changes are proposed in the SCR Act to give SEBI powers to impose fines on non-compliant companies and stock exchanges the powers to delist companies under certain circumstances. When implemented, this could address the current enforcement gap.

Investigations and enforcement action in market misconduct, such as insider trading and unfair trade practices

SEBI conducts investigations into market misconduct issues like market manipulation and price rigging, public issue related manipulation, insider trading, and violation of the takeover provisions. Of the 657 cases investigated since 1992-93, investigations have been completed in about 424 cases. However, successful prosecution based on investigative findings has been quite limited. Table 2 below gives the number of prosecutions *initiated* by SEBI under the SEBI act and the delegated sections of the CA. The figures on the number of prosecutions successfully completed are not available. In the case of insider trading and prohibition of unfair trade practices, the prosecution rate has been very small. In the first nine years since the insider trading regulations were issued in 1992, prosecution was initiated in only one case of insider trading. Similarly, in the case of market misconduct like manipulation, price rigging etc., prosecution was initiated only in seven cases until 2001.[72] The low number of prosecutions has been attributed to SEBI's pre-2001 lack of powers to investigate. Another reason cited is the multiplicity of regulatory agencies, which may allow the regulated entities to take advantages of the overlaps and gaps in regulation.

Prior to 2001, SEBI could not call for information from non-intermediaries; it also lacked the power to search and seize documents for evidence and to impound documents and a clear definition of what constitutes unfair trade practices and hence could be considered as cognizable offences was lacking etc. These powers have since been provided through an amendment to the SEBI act in 2002 and amendments to the SEBI Insider Trading Regulations in 2002. These reforms appear to have had a positive effect on the number of prosecutions *initiated* by SEBI for market misconduct cases. For instance, in the last two years prosecution has been initiated by the regulator in six cases of insider trading in 31 cases of fraudulent and unfair trade practices.

[72] Report of the Joint Committee on Stock Market Scam and matters relating thereto, Volume-I, December 2002.

Table 2: Nature Of Prosecution Initiated by SEBI between 1994 to 2003

Particulars	**1994-95**	**1995-96**	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**Total**
Under powers delegated under the Companies Act										
Delay in refund of excess application money, delay in transfer of shares and non-payment of dividend	4	3	4	6	4	10	4	0	4	**39**
Mis-statement in offer document and fraudulent inducement	0	2	3	2	1	3	4	1	0	**16**
Particulars	**1994-95**	**1995-96**	**1996-97**	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**Total**
Under the SEBI Act										
Violation of SEBI (Substantial Acquisition of Shares and Take-overs) Regulations, 1997	0	0	2	1	4	1	0	1	**1**	**10**
Violation of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to the securities Market) Regulations, 1995	0	0	0	2	4	1	0	5	**26**	**38**
Violation of SEBI (Insider Trading) Regulations, 1992	0	0	0	0	1	0	0	1	**5**	**7**
Violation of SEBI (Portfolio Managers) Rules, 1993	0	0	0	0	0	2	0	0	**1**	**3**
Unregistered entities (incl. CIS)	0	0	0	0	0	2	0	97	**153**	**252**
Indian Penal Code, 1860	0	0	0	0	0	0	0	0	1	1
Depositories Act, 1006	0	0	0	0	0	0	0	0	9	9
Securities Contracts (Regulation) Act, 1956	0	0	0	0	0	0	0	0	**14**	14
Others: non-cooperation during Investigation proceedings	0	0	0	0	1	0	12	0	13	26
Non payment of penalty amount imposed by the Adjudicating Officer	0	0	0	0	0	0	0	4	2	6
Total	4	5	9	11	15	19	20	109	**229**	**421**

Source: SEBI Annual Report 2002-2003

Vanishing companies

A number of companies that had collected funds in the past through public issues, have not been able to be traced. To take action against such companies and bring their directors to justice, a number of initiatives have been taken, including the establishment of the Central Coordination and Monitoring Committee (CCMC), with the Secretary of the DCA and Chairman of SEBI as its co-chairmen. However, only limited success has been achieved. Clearly, the enforcement procedures are cumbersome, time-consuming and involve too many agencies. This highlights the need to streamline the procedures to quickly detect frauds and take appropriate remedial measures.

Investor grievances pertaining to transfer of shares and non-receipt of dividend

Investor grievances against listed companies falling within the purview of SEBI are classified into six broad types of grievances[73]. In addition, investor complaints pertaining to mutual funds and dematerialization of shares and complaints against market intermediaries are also taken up by SEBI. The redress rate of SEBI in resolving complaints received in the above categories has been improving over the years from 21 per cent in 1991-92 to 95 per cent in 2002-2003 (Table-3). However, the absolute numbers of complaints received so far, as can be seen, are on the higher side. The complaints yet to be resolved at the end of the last financial year are about 135,000.

Table 3- Redress of Investor Grievances by SEBI since 1992

Financial Year (End March)	Grievances received (Cumulative)	Grievances Resolved (Cumulative)	Redress rate, %
1991-92	18,794	4,061	21.61
1992-93	129,111	27,007	20.92
1993-94	713,773	366,524	51.35
1994-95	1,229,853	718,366	58.41
1995-96	1,606,331	1,034,018	64.37
1996-97	1,823,725	1,465,883	80.38
1997-98	2,335,232	2,142,438	91.74
1998-99	2,434,364	2,269,665	93.24
1999-00	2,532,969	2,416,218	95.39
2000-01	2,629,882	2,501,801	95.13
2001-02	2,711,482	2,572,129	94.86
2002-03	2,748,916	2,611,101	94.99

Source: SEBI Annual Report 2002-2003

While the redress rate is notable, data on age-wise pending status of the complaints is not available in the SEBI Annual report. The complaint redress mechanism relies on the company to provide the redress status of complaints forwarded to them for resolution. In case the company does not resolve the problem within a reasonable time, moral suasion (through meetings with the compliance officers of the company), warning letters, incentive based mechanisms for resolution (linking regulatory approvals and permissions sought by the company to the record of the company in redressing investor complaints) and prosecution in extreme cases is adopted. Nevertheless, the redress mechanism is not the most efficient method to pursue as it requires a substantial amount of resources and manpower of the regulator. To prove a deterrent for errant companies which fail to redress investor grievances, the recent amendment of the SEBI Act in 2002 has empowered SEBI to impose a penalty of Rs 100,000 (USD 2,200) for each day of non-compliance or Rs 10 million (USD 220,000), whichever is less. This power is now being tested through SEBI initiating action against 18 companies for being repeated violators and not redressing investor grievances.

[73] Type-I: Issue related i.e. non-receipt of refund order/allotment advice, cancelled stock invests; Type-II: Non-receipt of dividend; Type-III: Shares related i.e. non-receipt of share certificates; Type-IV: Debenture related, i.e. non-receipt of deb. certificates, non-receipt of interest warrant; Type-V: Non-receipt of letter of offer for rights and interest on delayed payment of refund orders; Type-VI: Complaints related to collective investment schemes.

Annex D: The Insider Dealing Investigation of Samir Arora

On August 9, 2003, the Securities and Exchange Board of India (SEBI) banned Samir Arora, former chief investment officer of Alliance Mutual Fund, from dealing in securities for insider trading. Samir Arora was subsequently prohibited from buying, selling or dealing in securities until further notice, and it was announced that appropriate action would be taken against Alliance Capital's directors/trustees upon the conclusion of the investigations. The charges ranged from rigging bids, trading on insider information, and failing to make proper disclosures.

The first charge stems from events during Alliance Capital Management L.P. (ACM)'s attempts to exit the Indian mutual fund market between October 2002 and January 2003 through the sale of its stake in Alliance Capital Asset Management (I) Pvt. Ltd. (ACAML), the asset management company of Alliance Mutual Fund (ACMF).[1] ACM initially received 11 bids; it is charged that of the five that proceeded to the next round, one, Henderson Global Investors, approached ACM to confidentially preempt the bidding process and offered Rs 16.3 crore[2] (USD 36 million). Investigations showed that during the negotiation process between November 2002 and January 2003, ACMF saw an unprecedented 35 percent decline in its assets under management. At the time, Arora, head of Asian Emerging Markets of ACM (Singapore), was involved in investment decisions at ACMF and managing aspects of ACM's Asian Funds. Henderson promised Arora an immediate 6 percent stake in the new company and another 13 percent over the next five years, a total potential gain for Arora of Rs 30 crore. Arora told the press that he was leaving Alliance, and told Alliance management that he would only work for Henderson. Other equity analysts working with him followed suit. SEBI says these signals led to panic among Alliance unit holders. Redemptions followed, and the fund had to liquidate substantial holdings. According to SEBI, these actions reduced the fund's value, making it cheaper for Henderson to acquire.

Another charge deals with Arora's transactions in shares of Digital GlobalSoft just before its de-merger with Hewlett-Packard India Software Operations (HPISO). Arora is said to have had prior price-sensitive information on the share-merger ratio between the two firms, and deeming it adverse, sold Digital GlobalSoft shares (Rs 14.66 lakh[3] or USD 32,252) on behalf of ACMF and ACM before it was made public; Arora-managed funds avoided potential losses of Rs 24 crore (USD 5.28 million).

In addition, SEBI found that Arora managed significant funds in a manner that was not transparent and that he used close relations with management of companies in which he invested to gain price-sensitive information that impacted his investment decisions. Arora's reports to the press on the investment potential of various vehicles were allegedly with the intent to bolster the value of investments to his funds' benefit.

Further, it is charged that ACMF and sub-accounts of ACM failed to make adequate disclosures when they acquired more than 5 percent or when their shareholdings changed by more than 2 percent in companies such as Mastek, Digital GlobalSoft, Hinduja TMT, Balaji Telefilms and United Phosphorus as required by SEBI takeover and prohibition of insider trading regulations.

The case is still underway. It is however, an important one for SEBI, as it is the first time the market regulator has invoked its unfair trade practice clauses of the SEBI Act. Insider trading cases have been filed in the past, but none have yet been concluded.

[1]SEBI investigations revealed that ACM USA is the parent of Alliance Capital Management of Delaware, which sponsored Alliance Capital Mutual Fund (ACMF). ACANL is ACMF's asset management company and is a subsidiary to Alliance Capital (Mauritius) P Ltd, whose parent is ACM. ACM is therefore ACAML's parent.
[2]Crore is a unit of measure used in India to denote the number 10 million.
[3]Lakh is a unit of measure used in India to denote the number 100,000.

Sources:
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