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Corporate Governance: An Emerging Scenario

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1. Introduction

As the country races towards the end of the first decade of the new millennium, it is perhaps appropriate to take stock of the events and developments during this period and to plan out an action agenda for the decade ahead. While such a stock-taking exercise could (and should) include several fronts that are of national importance, this review exclusively focuses on the governance of business enterprises in a corporate format, especially those whose securities are listed and publicly traded. Needless to say, most of the issues discussed and the recommendations made in this context are applicable to other entities (like unlisted public and private limited companies) and also to those using other organisational formats (such as cooperatives, trusts, and associations of persons) where those in operational control of such institutions owe some fiduciary obligations to others who are not so positioned.

Although the term *corporate governance* in its present connotation seems to have gained currency in recent times and has been strengthened with every major corporate misdemeanour or financial distress in the recent past, the concept itself is not new. Drawing upon the basic political and ethical principles which underline the responsibility of those in authority to others in their realm, business corporations have traditionally been required to discharge their trusteeship obligations to their constituents, and to act in their collective interest. Of course, from time to time, this onerous responsibility has been flouted by those in authority, with abuses of their power for personal advantage and aggrandisement. The tyranny of the majority—and equally, of the minority—has also been observed in the field of public policy and administration. This has been, and continues to be, the case with the governance of the corporate sector as well. Minimising such unacceptable behaviour becomes an issue of major concern (given the improbability of totally prevention), and this is sought to be achieved by instituting countervailing systems and institutions to protect the liberty of the individual constituents (Mill, 1859), whether they are the citizens of a country or the shareholders of a corporation. Such systemic checks and balances manifest themselves in legislative and regulatory mandates but their efficacy is determined by the effectiveness of their application in practice through timely and rigorous enforcement.

We begin with a brief review of the major developments in the field of corporate governance in recent times, especially during the last decade. We then deal with some key issues in the effective achievement of good corporate governance goals, interspersing our discussion with a prescriptive list of desired action initiatives.

2. Recent Developments in Corporate Governance

Most of the governance requirements relating to corporations in India till the end of the twentieth century have all been essentially in the form of legislation. The Companies Act of 1956 is still the basic statute, although it has been amended several times over the years. This Act will soon be modified by a more modern and relevant legislation when the Companies Bill 2009 currently before the Indian parliament (at the time of writing) enters the statute book. The Standing Committee on Finance (2009–2010) has already reviewed and submitted its report on the Bill. This initiative is an important step forward in the process of corporate governance reforms. While a comprehensive critique of the Bill and the Standing Committee's report is beyond the scope of this paper, it is important to mention that several of the measures proposed with regard to the governance of corporations leave a lot to be desired;

in many cases, these proposed measures represent a retrograde slide back to the bureaucratic control and permits regime of the past. Clearly this is inconsistent with the general trends of progressive liberalisation that have been pursued by the government with substantial success over the past two decades. An extraordinarily heavy dependence on subordinate legislation—235 separate instances of "as may be prescribed" in the Bill provisions as has been rightly pointed out in the Standing Committee's report (2010, p. 20) and in earlier critiques like Balasubramanian (2004, pp. 6–7) among others—goes against the progressive view that matters of public policy should come largely under parliamentary review rather than being addressed by the bureaucracy.[1] The assumption that the government (and its bureaucracy) knows best and can successfully drive businesses from the backseat is an outdated concept that has been proved ineffective time and again. Rather than overseeing company performance in key areas of governance, the Bill seeks to retain decision-making powers within the purview of the government, with companies having to seek approval on a variety of matters including the size of their boards and the separation of the positions of board chairs and CEOs. The government, on the other hand, could have signalled a stronger message for good corporate governance by improving and updating governance practices and shareholder protection measures in public sector enterprises, which the private sector could have been encouraged to emulate.

The first formal documentation in recent times of desirable standards of corporate governance in the country was brought out by the Confederation of Indian Industry's report (CII, 1998). While it fell short of international standards and best practices (Balasubramanian, 1998), as a self-regulatory industry initiative it was unique and path breaking. Being recommendatory in nature, only a handful of its member companies ventured to adopt the measures suggested in it to usher in improvements in their governance.

This was followed by the recommendations of a Committee on Corporate Excellence (2000) headed by Sanjiva Reddy, secretary of the (then) Department of Company Affairs. Many of its recommendations—

such as restricting voting rights of interested shareholders at general meetings, empowering independent directors through quorum requirements, ensuring majority independent directors' presence at meetings and key resolutions having to be voted for by a majority of independent directors—were probably far ahead of their time.[2] Although these recommendations were broadly accepted in principle, and some were even implemented in phases including the one that eventually led to the formation of the National Foundation for Corporate Governance as a non-governmental body to promote corporate governance in the country, this committee and its report never received the attention and publicity that they deserved. As a result, this initiative has remained largely unnoticed, relegated to the archives of the Ministry of Corporate Affairs. Around the same time major regulatory reforms were ushered in by the Securities and Exchange Board of India (SEBI) through the introduction of the now famous clause 49 of the Stock Exchange Listing Agreements based on the recommendations of the Kumar Mangalam Birla Committee on Corporate Governance (1999). These were further refined and improved upon when the recommendations of the Narayana Murthy Committee (2006) were implemented, effective 2008.

There has thus been a crowded programme of legislative and regulatory reforms during this decade. Most of these efforts have been directed towards bringing the corporate governance standards in the country closer to internationally accepted levels of corporate conduct and responsibility. There would still be gaps inevitably, and one hopes that these would be addressed over time, so that India's standing as a desirable and acceptable investment destination gets further strengthened.

The greedy dimensions of corporate and human behaviour

While the country's record of legislative and regulatory improvement has been more than satisfactory, there have also been several instances of corporate misdemeanours during this decade. At the top of the list was the major fraud at Satyam Computers, the fourth largest Indian software services company (after TCS, Infosys, and Wipro). This fraud was perpetrated over a seven to eight year period during the decade by the

CEO,[3] who had until his confession in January 2009 enjoyed a very high personal reputation for integrity and model behaviour. This episode also brought out a rare display of institutional investor activism and resistance, where dubious corporate decisions that were seen as patently enriching those in operational control at the expense of other shareholders were disapproved. Regrettably, this disaster also showed board independence and oversight diligence in the most unfavourable light, especially since the company's star-studded board satisfied the most desirable prerequisites of ideal composition and structure. Another major casualty in this incident was the institution of independent audit, and the reputational credibility of even internationally well known audit firms. While damage control measures did indeed salvage the company and the image of the country thanks to some exemplary initiatives by the government and the industry itself, the scars of this mega scam will probably take a long time to fade away.

Among the other corporate and capital market scams were the Ketan Parekh heist in 2002 (along the lines of a similar fraud perpetrated by Harshad Mehta a decade earlier) where the Bank of India, Madhavpura Cooperative Bank and others lost billions of rupees, the insider trading scam involving the Monthly Income Plan investments in Unit Trust of India where scores of large business houses were able to foreclose their investments while millions of small unit holders were left to bear the losses, the phenomenon of disappearing companies on the stock exchanges after their public offers for subscription, the notorious Z list of companies of dubious credentials on the Bombay Stock Exchange, and so on. Much of the fraudulent and often irresponsible behaviour of the fraudsters was facilitated by lax controls and monitoring systems within the companies as well as in the operation of the regulatory systems.

What is discovered and publicised is often a fraction of what goes undetected. If India has not had corporate scams of the size and number many other countries have reported, it is probably due to our relatively poor monitoring and preemptive mechanisms. There is therefore little room for complacency on this account. We now turn to a consideration of some key issues and impediments that bear upon ensuring good corporate governance.

3. Potential factors impairing good governance

In the large limited company format, there is virtually a complete separation of control from ownership, leading to principal-agent divergence of interests (Berle & Means, 1932); given this, there are obviously several inherent challenges to ensuring good corporate governance (Balasubramanian, 2009). These could be grouped under three broad heads—board independence and effectiveness, shareholder rights to protection from potential expropriation, and credible gate keeping and certification of disclosed information. The first subsumes themes like empowering director and board independence; the second includes issues like the ethics of exercising shareholder voting rights, board versus shareholder primacy (or the major shareholder versus the dispersed small shareholder primacy) , institutional investor activism, executive compensation, material related-party transactions, parent-subsidiary relationships, etc. The last essentially covers independent audit, governance and credit rating, corporate disciplining by regulatory bodies and stock exchanges, and so on.

From a general perspective of the country's image (an important consideration influencing direct investment flows) one should also explore good governance imperatives in business entities (many of which are large and systemically important) other than just the listed and publicly traded corporations. These would include banks and financial sector institutions, public sector enterprises, large but unlisted public and private companies, trusts and other forms of business organisation including cooperatives and joint ventures. The state of public and political governance in the country must underlie all these; it would be absurd to aspire for islands of excellence in terms of corporate governance without an equally vibrant, inclusive, transparent, and value-based governance structure at the level of the state and its public policy and service delivery systems. How can good governance be sought from corporations in isolation unless those in the field of public policy formulation set an example by practising matching or even superior standards of governance?

On board independence and effectiveness

Empowering independence of boards and directors

There is a fairly strong academic and practitioner attitude of scepticism about the inherent reality and contributory potential of the institution of independent directors. High profile corporate scandals in the recent decades certainly seem to lend support (at least anecdotally) to the emerging view that the institution of independent directors is an unnecessary burden on the corporation without any significant benefits to the investors and the society at large. There is also enough evidence of independent directors being fair-weather-friends of companies, sticking with them during good times and deserting them at the first sign of impending disasters (Fahlenbrach et al., 2010, pp. 22–23) or immediately after corporate scams or punitive legal judgements as was witnessed after the Satyam episode in 2009 and the Union Carbide (Bhopal) verdict in 2010. However, given the soundness of the underlying principles of objective and non-aligned review and surveillance over executive management (whether by professional managers or controlling shareholders) that this institution is positioned to provide in the interests of all absentee shareholders, it may be useful to explore how the mechanism could be strengthened to achieve its intended purpose more effectively (Balasubramanian, 2009). This would involve a discussion of the definition of independence in this context, how such independent directors are appointed and compensated for their time and effort, how their collective voice should be provided with more teeth to be really effective, how the abuse of such vested power should be treated and penalised, how their tenure should be protected to ensure unbiased contribution, and what the attendant features of their exit or separation before their term should be; these issues are taken up in detail below.

Defining independence

Over the years, the criteria in India for ascertaining director independence have been refined and brought closer to international best practice requirements, but there is still scope for further fine-tuning. Rather than mandating such requirements, laying down broad principles to be followed with a comply-or-explain caveat may be a more preferred option (Balasubramanian et al., 2006). This would ensure that the desired benchmarks are laid down giving the companies the option to follow them or deviate from them if deemed necessary as long as they provide suitable justifications to the shareholders, who can then make an informed assessment of the governance risks involved.

In a country like India where ownership structures are predominantly inclined towards concentrated holdings by promoters or groups (irrespective of whether they are domestic or family groups, MNCs or the state), the foremost criterion for determining the independence of an individual should be his/her association with not only the subject company but also the group entities and power centres as a whole. The present regulatory provisions do not seem to fully take this important fact into account. Whether or not an individual is a non-executive director in another entity controlled and/or owned by the same parent or some other entity or individual that is influenced by the subject company usually gets ignored when considering linkages with the promoter for the purpose of determining the individual's independence in the subject company (even though the remuneration received collectively from all such entities may be material to the individual). One should recall that it is only the remuneration received from the subject company as its director (and not from other connected entities) which is excluded in determining individual independence; this important aspect seems to be overlooked wittingly or unwittingly in most such cases.

Companies in India (and in a handful of other countries) have the practice of retaining on their boards non-executive directors who do not qualify as independent under the prescribed criteria. While this practice may have been a necessary transitional measure, it is perhaps time to phase this institution out over the next few years. One way of achieving this objective would be to lay down a progressively diminishing maximum proportion of the board that can be non-executive-non-independent. This would also probably pave the way for the induction of more independent directors without unduly increasing the overall board size.

Appointment and remuneration of independent directors

Much of the criticism on the behavioural incapacity of independent directors to disagree with the promoters or management to whom they are beholden for their jobs is based on the fairly fundamental human reluctance to bite the hand that feeds them. It is probably for this underlying reason that international best practice calls for such selections and appointments to be made by a Nominations Committee which is wholly composed of independent directors. Indian regulation needs to move towards this practice sooner rather than later. Also, it would be appropriate for the appointment to be made in the name of the board and conveyed to the individual by the board chair together with at least one senior independent director, in order to reinforce the need for allegiance to the company and its shareholders rather than to the CEO or the executive chair in his/her personal capacity.

The matter of independent directors' compensation often leads to a discussion on whether an overly generous package—especially profit-based commissions and stock options—tends to erode director independence. There is merit in this argument, and it is heartening to note that the voluntary corporate governance guidelines of the Ministry of Corporate Affairs (MCA, 2009) suggest eschewing such methods of compensation. On the other hand, there are jurisdictions elsewhere (like the US and the UK) which actively encourage the allocation of some part of the compensation in the form of equity so as to better align the long-term interests of directors and shareholders. There are at least two potential pitfalls to guard against even while benefiting from such congruence of interests. The first is the possible temptation to embrace creative accounting and other devices to enhance company profits if the stock allocations are profit-based. The second and the more pernicious danger is the potential for insider trading—directors may be tempted to cash in on the privileged information available to them. The first can be tackled by a truly independent audit scrutiny, while the latter can be contained through suitable restrictive covenants of holdings lock-in until the end of the directors' tenure.

The concept of materiality also needs to be interpreted more rigorously. If a director's independence is assumed to be under threat because of high compensation, then its materiality should be linked to the individual's income and wealth rather than to the size and earning of the company paying the compensation. This also highlights the possibility that the same remuneration for all the directors on a board may have different shades of materiality with respect to different members. One way of encouraging continuing independence in such cases may be for the chair and the other directors to reach out and seek the views of such members during board discussions, and to encourage free and open debate on issues so as to help such directors overcome any personal or behavioural problems that they may have.

Giving independence an effective voice

Even when board independence is well secured, there are inherent limitations in the current legislation and regulation that militate against effectively pursuing the collective independent view to its logical conclusion. Unlike the German model of duel boards where the executive management is separated from the supervisory board, the Anglo-Saxon single-board structure neutralises to an extent the effectiveness of the independent elements in the board, which more often than not is not a significant majority (since regulation does not mandate it). One way of overcoming this problem would be to ensure that the independent view is "enabled" to be heard and acted upon (Balasubramanian, 2009). Two key enablers are described below.

- Currently quorum requirements for board and committee meetings do not mandate the presence of any of the non-aligned directors. Theoretically, it would be possible to have a valid board meeting with only executive directors in attendance who approve important decisions, notwithstanding the presence/absence of the independent directors on the board. For the role of non-aligned directors to be effective, it is important that board meetings necessarily require their presence or at least the presence of a majority of such directors at the meeting.

- Equally, it is important to mandate that certain key decisions on specific topics can be approved by the board only if a majority of the independent directors of the company in totality (and not just a majority of those present at the meeting) vote in support. This provision would ensure that the independent directors' opinions are heard and their votes count.

Two major concerns can legitimately be voiced against such special empowerment of independent directors—one is conceptual and the other practical. It could be pointed out that all directors are created equal, with similar fiduciary obligations and liabilities. Conferring special powers on some of them and enabling them to veto a majority of the other members of the board amounts to downgrading the others' importance and value to the company, and is patently unfair. This is apparently a strong argument for the equality of voting rights. However, equity demands that unequals be treated unequally—directors in executive capacities are performing the role of *agents* in the governance hierarchy, and to that extent their personal agenda can potentially be incongruent with the principals' agenda in terms of wealth creation for and distribution to the latter. Since one of the key responsibilities of the board is oversight and monitoring of the executive management, it would not be unfair to ensure that the non-aligned directors—who have been specifically inducted on to the boards in order to carry out such unbiased and independent evaluations and monitoring in the interests of shareholders—are in fact present and participating, and that a meeting without their full presence (or at least a majority of their presence) is disempowered to take critical decisions.

Additionally, it could be argued that such virtual "veto" powers in the hands of independent directors may be open to abuse and in extreme cases could also encourage some form of blackmailing or extortion. This is a valid point since power in any form is often an invitation to potential abuse, and after all, non-aligned directors are equally subject to human failings. Keeping this vulnerability in view, our recommendation is for approvals by a majority of the independent directors and not by all such directors. It is highly improbable that independent directors would all get together to unreasonably withhold consent related to matters that are in the overall interests of the company. As a further measure of prudence and deterrence against such abuse of authority, it may be appropriate to set up a quasi-judicial, autonomous National Corporate Governance Authority (NCGA) for transparent peer review by expert panels of uninvolved, experienced directors, and other people of eminence, who would look at complaints of any such abuse of power by non-aligned directors. If abuse is proved, the guilty should be handed down the most stringent penalties including disgorgement of any personal gains with salutary penalties and debarment from directorship of any corporate entity where other people's monies and resources are involved. To ensure that the accused non-aligned directors also have a fair dispensation of justice, they should have a right of appeal to the highest court against the decisions of the NCGA. With these systemic checks and balances in place, it should be possible to allay fears of any abuse of these provisions.

Assured tenure and mid-term separations

For any person in authority to function without fear or favour, an assurance of a fixed tenure of office would function as a great source of motivation. It is desirable that independent directors are appointed for an assured term, of three years for example, during which he or she could be impeached and dismissed only on certain specified grounds and after following due processes. Current law in effect provides for a three-year term for most directors on the boards of companies since it requires one-third of the board (except certain executive positions) to retire by rotation each year, with no bar on re-election. What may be more meaningful in the context of board and director independence is to make the appointments independent director for assured fixed terms of three years each. Concomitantly, specific grounds and processes for mid-term dismissal must also be mandated. The grounds could include, for instance, continued absence from board and committee attendance, moral turpitude, criminal convictions even in cases unconnected with the company, observed anti-company activities, etc. Such dismissals should be discussed and recommended for shareholder approval by a fully attended board with a majority of other independent directors voting, and the members at the general meeting should approve the recommendation of the board for such dismissals.

Of course, independent directors must be allowed the freedom to resign mid-term if they choose to do so, albeit with certain restrictions. The present practice (which is in compliance with law) is for the board to accept the resignation. This is conceptually incorrect. Theoretically, directors are elected by the members in a general meeting and they owe their fiduciary responsibility to the shareholders; unless otherwise authorised, they should submit their resignation to those who appointed them. Even more importantly, they owe it to the members to explain why they were resigning mid-term and to be personally present (unless circumstances prevent such a course of action) to answer any questions shareholders may have regarding their decision to resign. The standard explanations that the resignation was "for personal reasons" or "on health grounds" are for the most part patently frivolous and a travesty of justice as far as those who appointed these directors to act on their behalf are concerned. Most companies carry out exit interviews when even middle and junior level employees leave their jobs; do the shareholders deserve anything less when their elected directors decide to quit before their term?

On shareholder rights and responsibilities

The second set of challenges to improved governance stems from and is related to the principals themselves—the shareholders. Voltaire, the noted French philosopher, insightfully described why people agree to become citizens of civic and political communities even though such a decision may necessitate some sacrifice of individual freedom and subjection to the group discipline. The principal motivation, he reasoned, was the assurance of security and peaceful co-existence in pursuit of individual economic and other goals which may not be possible without such structural agglomeration into communities and nation states. The rationalisation for absentee shareholders investing in corporations is somewhat similar to this—they may be well aware that they may not receive the full benefits that ought to flow to them as a result of successful business operations, but they are willing to make this sacrifice because they by themselves, with their limited resources and expertise, may not be able to initiate and sustain such business ventures. Having agreed to incorporate themselves into a body corporate (which is what the Memorandum of Association of companies signifies) and also having reconciled to delegating the task of overseeing and carrying on the business of the corporation to a body of elected representatives (which is what the board and directors are all about), should the principals be relegated to the position of helpless bystanders? Shouldn't there be a far more elegant framework than what currently exists, which would enable shareholders as a collective body to exercise their rights to determine broad guidelines as to how major and material aspects of the corporation's business—*their* business—should be run for the equitable benefit of all of them? To be meaningful, this would of course require a much higher level of application and engagement on the part of institutional and other block shareholders to enable them to discharge this responsibility effectively, but they owe it to their own constituencies whose monies they are deploying in the equities of the investee companies.

Board versus shareholder primacy

This then leads on to a discussion of the crucial issue of primacy in governing the corporation—is it the corporate board or the collective body of shareholders that is supreme? In the last decade and a half, the views expressed on this issue among legal scholars have been polarised (Bainbridge, 2005; Bebchuk, 2005, 2006; Strine, 2006) especially with reference to the corporate law in the US, more specifically in Delaware. It is well established that in the case of large public corporations, shareholders running into millions cannot possibly have a say in the operations of their companies, and that this task must be delegated to the board of directors and through them to executive management. But the question is: to what extent should and could shareholders have a voice in shaping not only the policies but also the people who will conceptualise and consummate those policies? In some ways, the Indian position is way ahead of the US situation on many aspects of shareholder empowerment. For example, in India, shareholders elect their directors individually, not as a slate as in the US; shareholders vote on directorial remuneration unlike in the US where it is only in recent times that the "say-in-pay" movement has been gaining ground; there is a provision for electing a small shareholders' representative on the board in India, while there is no such provision in the US; there are postal ballot provisions on certain key issues with no corresponding provisions in the US; and there are express provisions on what the boards cannot do without shareholder approval in India, while similar limitations do not apply in the US. There are two major weaknesses in the Indian regime though—there is very little institutional investor activism and there is relatively poor implementation, monitoring and disciplining routines in practice; the US scores better on both these counts.

Shareholder power: A reality check

Although Indian law offers certain rights to the shareholders on some key matters of corporate policy and operation, in practice, their real value is largely circumscribed partly by shareholder apathy and more importantly by inherent design deficiencies in the suffrage systems which are in operation. While the indifference exhibited by a vast majority of small investors may be justified (since many of them may not have the time, inclination, expertise, or economic motivation to warrant greater attention), much greater involvement and contribution should be forthcoming from block holders and institutional investors. Even more importantly, such institutions—as responsible shareholders often with their own fiduciary obligations to their own constituents—need to play a proactive role in ensuring that the governance risks in their investee companies are minimised. More transparency in communicating their position and voting strategies on key resolutions of their investee companies is also required. On rare occasions (such as in the Satyam episode), institutional investor activism has indeed preempted the blatant abuse of corporate power, but there is a strong case for some kind of an organised structure (such as the Council of Institutional Investors in the US, or the International

Corporate Governance Network in the UK) to provide an ever-vigilant and well-informed shareholder review and resistance platform as a possible insurance against recurring corporate misdemeanours.

The second impediment to purposeful shareholder interventions has to do with the voting regimes in existence, and is a much more serious matter since it involves inherent voting biases that militate against the meaningful exercise of absentee shareholder power over corporate boards and managements. As the law has evolved over the decades, all shareholders within the same class or category are equal in their voting entitlements. While this principle is equitable and beyond question, problems may arise when some of the shareholders in the same class are negatively impacted by a decision while others may not be so impacted or may even benefit positively by the decision. In such circumstances, those who stand to benefit ought not to vote on such resolutions in the members' meetings. Related-party transactions involving matters such as group company mergers and divestitures, preferential share issues, setting up competing subsidiaries and other entities, transferring favourable corporate opportunities to other group companies or unfavourable opportunities from other group entities to the disadvantage of the other shareholders, and executive remuneration of shareholder managers are some of the issues that should attract such restraint on the part of interested or benefitting shareholders in general meetings. The boards in such situations may be ineffective in preventing such resolutions since the controlling shareholders could always have them approved at general meetings of members where they can vote their block of shares in favour of such resolutions.

Sweden (Pierce 2010, p. 622),[4] Singapore, and Hong Kong are some of the countries that have such provisions in place;[5] Balasubramanian (2010, pp. 305–309) discusses some of the other countries which have similar provisions. Overall, the restraints regime imposed on controlling and self-interested shareholders rests on the equity premise that those who are in management or directorial control of the corporations and those shareholders who stand to materially benefit from a self-interested transaction—financially or otherwise—should seek and defer to the decision of the majority of the other (negatively impacted) shareholders.

There would be strong objections to the introduction of such provisions in Indian law or regulation as they would seriously compromise the sanguine complacency with which such resolutions could be pushed through under the present dispensation. A key argument that would be (and has been) advanced is that shareholders have no fiduciary obligations to other shareholders, and are entitled to vote their shares in their own best interest. But the position is materially different when it is the controlling shareholders (as directors) and the executive managements of companies that propose such resolutions in their own favour; in such circumstances, their fiduciary obligations to the company and to shareholders should take precedence over their own rights.

This wholly ethical and equitable principle has been upheld even in the most unlikely situations and circumstances. For example, it would be ironical to associate such sentiments with any of the ruthless capitalist pioneers who strode the US scene in its early decades of development (when even insider trading as it is known today was not frowned upon); but there seems to have been at least one recorded instance involving the nineteenth century colossus Vanderbilt, foremost among the robber barons of that era. On his death in January 1877, the directors of the several railroad companies that he had founded and nurtured issued a joint tribute which contained the following statement germane to our discussion (Stiles, 2009, p. 566):

> It is to his lasting honor that his uniform policy was to protect, develop, and improve the interests with which he was connected, instead of seeking a selfish and dishonorable profit through their detriment and sacrifice. The rights and welfare of the smallest stockholder were as well guarded as his own... .

Recommendations to introduce the concept of "interested shareholders" and to enforce restrictions on their voting rights on those resolutions benefitting them to the exclusion of other shareholders had in fact been made by the committee on corporate excellence through governance (2000); however, Indian legislation and regulation are yet to implement these recommendations. On the basis of a further representation, the Irani Committee (2005, para 35) did indeed refer to this issue as follows, but stopped short of recommending legislation on grounds that there could be practical difficulties in implementation.

> The Committee considered the concept of exclusion of interested shareholders from participation in the General Meeting in events of conflict of interest. The Committee felt that this was an aspect of good Corporate Governance which may be adopted by companies on voluntary basis by making a provision in the Articles of Association of the company. In view of the issues related with enforcing compliance of such requirements, there need not be any specific legal provision for the purpose.

The standing committee on finance has also not commented upon or recommended any legislative changes in the Bill pending before parliament (at the time of writing). Unfortunately, a great opportunity to introduce a path breaking reform thus seems to have been lost at least for the time being. Can our politicians—in their role as conscience keepers of the nation—revisit this key issue when the Bill comes up for discussion in parliament and bring about this change? Without such an equitable and elementary preemption, all endeavours to protect minority or absentee shareholder interests would remain well-intentioned sentiments on paper with little or no practical application or relevance.

Executive compensation

Among the issues related to corporate behaviour that have generated animated debate in recent years is the subject of executive compensation. The global financial meltdown in 2008–2009 and the heavy price that countries around the world had to pay to restore a semblance of normalcy have further exacerbated this already sensitive issue of what is considered as unbridled greed on the part of executive management, especially in the financial sector.[6] Regulatory interventions—that would have been previously unthinkable in open market economies like the US and the UK—have been witnessed, although an apparently unrepentant private business seems to be carrying on regardless of all this.[7]

India has a history of government intervention in managerial remuneration, although more on the grounds of public policy interest dictated by political (i.e. socialist) considerations in the latter half of the twentieth century. The limitations placed on the corporate sector pay in India were so unrealistic that there was an increasing tendency to resort to off-the-record methods for compensating executive directors. Thankfully, most of such draconian rules are a thing of the past, although some of the excesses observed in the Indian corporate sector—further prompted by moves to curb excessive remuneration practices in the West—clearly portend an unwelcome return to the regulatory regimes of the past.

In discussing executive compensation reforms in the Indian context, it is important to bear in mind the following key aspects. Unlike in the US where the compensation committee and the board determine and approve executive remuneration packages (even the current "say-in-pay" moves speak only of non-binding shareholder interventions), in India the remuneration packages of directors have to be individually "approved" by the shareholders in a general meeting. This is an important distinction, even though Indian general meetings of shareholders are not wholly effective for discussing and making informed decisions related to such issues (as was noted earlier). As a result of this divergence, while the compensation committees in the US have only to satisfy themselves that what they are approving is the right package under the circumstances, in India the compensation committee is obligated to go that extra mile to explain and convince their shareholders that what they recommend is in fact the best for the company in terms of its value-creating imperatives. The board report, explanatory statements to the resolutions, compensation discussion and analysis, or whatever else is required to be presented to the shareholders must meet this fundamental objective.

Share ownership of corporate India is predominantly skewed towards concentrated holdings by domestic and family groups, multinationals, and the state, unlike in the US and the UK. Very often, executive compensation packages that come up to the members for approval pertain to those dominant share owners themselves or their representatives, which makes them similar to related-party transactions between the companies and their controlling owners/managers. In such cases, the controlling owners and managers should refrain from voting on resolutions relating to their or their representatives' compensation (as was discussed earlier). It should be left to the board, its compensation committees, and those shareholders without any interest at stake to take a call and to approve or reject such compensation packages. (And if the unrelated shareholders especially of the institutional variety do not apply their mind and vote on such resolutions, they should have no complaints later that executive compensation especially that of companies was excessive or unreasonable. In fact, their own constituents should question such institutional investors regarding how they justify their decisions to approve or abstain from such resolutions.)

The members of the compensation committee owe it to themselves and to their shareholders to exercise proper due diligence in satisfying themselves that the proposals they are approving or recommending for shareholder approval would stand the test of sound reason and business logic. Writing several years ago, Jensen and Murphy (2004, p. 51) had this salutary counsel to offer to members of the compensation committees.[8]

> Remuneration committees must take full control of the remuneration process, policies, and practices. In particular remuneration committees should jealously guard their initiation rights over executive remuneration. They must abandon the role of simply ratifying management's remuneration initiatives. Obviously [this] does not mean that committees should make decisions and recommendations to the whole board without discussions with management, but this is quite different from allowing management to *de facto* seize the remuneration initiation rights. Remuneration

> committees can ask for data or information from corporate human resource officers, but these officers should report directly to the committee (and not to top management) for committee related assignments.

Often, references are made to international compensation levels to justify the proposed compensation packages. Such arguments are specious and meaningless since many other aspects of the Indian corporate scenario including earnings at other levels, product/service pricing and quality, input costs, general employment and income levels of people in the communities where the companies operate, etc cannot be compared to their international equivalents.

On gate keeping and regulatory discipline

The third group of issues that calls for attention is related to the importance and credibility of reputational agents whose primary purpose is to evolve a societally acceptable set of rules of the game and to ensure that the participants play by those rules, on pain of punishment for violation. Besides the state and its executive and judicial branches (a discussion of which is beyond the scope of this paper), there are at least two important reputational agencies whose role in ensuring good corporate governance in a country is paramount—the independent auditors and the regulators (including stock exchanges). We confine our discussion here to a brief analysis of the directions in which these agencies could strengthen the good governance movement in the country.

Independent audit

An indispensible component of good governance and an inevitable institution inherent in the principal-agent equation of the corporate format, independent audit has long been at the centre of controversy and at the receiving end of constant criticism. More than a decade ago researchers had asserted the impossibility of auditor independence based on psychological experiments (Bazerman et al., 1997, pp. 89–94).[9] Further compounding and clouding this complex relationship are apparently innocuous initiatives such as shareholders leaving audit remuneration to be fixed by the board or audit committee (which eventually translates to decisions being made by executive management), and independent auditor's close operational proximity and socialisation with executive management rather than an amorphous body of shareholders. Practices such as management letters pointing out errors and inadequacies to the management rather than to the board or audit committees let alone to shareholders also establish a relatively private and confidential relationship between executive management and the auditors, which is certainly not conducive to a strict arms-length relationship between the auditor and the auditee.

Research evidence also shows that audit qualifications do not have any major impact on the recipient shareholders—partly because of the delay in publication of these audit qualifications in the annual reports (by which time most of the investors are presumably aware of the problems anyway), and partly because of their perceived low-level importance in affecting a company's wealth-creating potential. This indifference on the part of the investing public (especially institutional shareholders) also leads to a false sense of complacency on the part of auditors that their reports do not materially add value to the shareholders, and hence misinformation either due to indifference, negligence, or in more serious cases even collusion are unlikely to impact them adversely.

While regulators around the world have tried to neutralise some of these deficiencies by various measures—auditor independence rules, peer reviews, regulatory oversight boards, and in extreme cases even punitive consequences—their perceived impact does not seem to have materially improved the overall impression of the institution of independent audit in terms of either its expected contribution or its achieved track record.
The following reforms concerning independent audit and auditors would be of special interest to India.

- At present in theory, any practising chartered accountant can be appointed to audit companies irrespective of their size or the auditor's own practical experience and bandwidth. It may be appropriate to initiate some regulatory measures that would restrict audits of at least large companies (for example all listed companies) to audit firms of some prescribed size, experience, and expertise. This would be similar to the SEC practice firms of accountants in the US. This might sound as a restriction of the potential role of a large number of accountants in practice, but in the long run such a measure might actually lead to the creation of medium-to-large sized firms of accountants. This would also ensure that the investing public is provided with a specially created pool of independent auditors whose reputational contributions would be found more credible.

- The disciplinary functions of the profession are best separated from the training, certifying, and supporting dimensions of professional development. Self-regulation, as is often observed, generally degenerates into no-regulation. An independent quasi-judicial entity entrusted with the task of prosecuting and punishing the guilty may well take the overall rating of the profession to a higher level.

- Very often, professional accountants appointed to audit a company's financials tend to take the task as an entry point to seek potential further business from other group companies. Audit fees are usually quite low. Company boards and shareholders are mostly responsible for this sorry state of affairs. In a large number of cases, the fees are worked out on the basis of work-hours spent on the job. It is high time that Indian corporations and shareholders began recognising audit certification for what it is—an independent service assuring absentee principals that executive management had deployed their resources as mandated, duly accounted for them, and faithfully reported back to the principals—and began compensating the auditors adequately for their services. An appropriate value-based fee structure for company audits determined by the board/audit committees on behalf of the shareholders would go a long way in not only attracting and encouraging best talent to the profession but also generally raising the value-perception of the reputational contribution that this valuable institution makes to minimise governance risks to the investors.

- A great deal has been written about the perceived and the actual independence of auditors as a determinant of their credibility and effectiveness. As in the case of independent directors, audit independence is also a matter of individual character and upbringing. As far as the pecuniary aspects of audit independence are concerned, most regulations and guidelines seem to take an insulated view of the audit firm by itself and its earnings from and business connections with the auditee company and its related entities. ("Group" is often the loosely used expression to denote these agglomerations since precise definitions are not easy to come by.) What may be of greater importance is the position of the audit firm in relation to its own "group" of associates and affiliates. It is necessary to capture some of the nuances involved in the professional groupings of firms, and how their interrelationships may be a factor in determining audit independence. For instance, it is not unusual for an international firm of accountants to have an international group of companies as its audit and consulting clients for different parts of that group. Although the Indian audit firm by its very constitution may be an independent entity, its independence in relation to the Indian subsidiary of the international group is likely to be influenced by the value of the international business from the group to the audit firm's international parents or associates. The extent to which the local audit firm and its signing partner would be insulated from their own internal pressures relative to the Indian client subsidiary's financials is something that one has to reckon with. Most of the Big Four audit firm practices around the world, with their focus on international client bases, are likely to suffer from this inherent networking disadvantage.[10] The manner in which companies, audit committees, and regulatory and professional bodies need to tackle these issues related to audit independence is a subject that needs to be studied and deliberated upon in great detail.

Role of regulatory bodies and stock exchanges in corporate disciplining

The imperatives of the rule of law in any civilised society can never be overemphasised. In an ideal society where everyone knows and abides by what is right behaviour, there would be little need for a code of do's and don'ts, much less for a punitive mechanism or *danda neeti* as described in the Indian scriptural tradition, to enforce the regulation. Since our society is not in that utopian state, and since both the *visible and invisible hands* of people drive them towards maximising their own interests even at the expense of others, there is a pressing compulsion to ensure not only that appropriate regulations exist but also that they are enforced in an effective and timely manner.

In pursuit of the investor protection objective which most capital market regulators embrace, what should be the key role of an organisation such as the Securities and Exchange Board of India (SEBI) in matters of corporate governance at listed companies? Mary Schapiro (2010, p. 3), the chairperson of the US Securities and Exchange Commission (SEC), was clear that:

> [T]he SEC's job is not to define for the market what constitutes "good" or "bad" governance, in a one-size-fits-all approach. Rather, the Commission's job is to ensure that our rules support effective communication and accountability among the triad of governance participants: shareholders, as the owners of the company; directors, whom the owners elect to oversee management; and executives, who manage the company day-to-day.

The notion of "investor protection" has often assumed a larger than life meaning in discussions in an attempt to cover every possible downside experienced by investors. Obviously this is not what investor protection is intended to connote. It is intended to ensure that the investors have full and fair communication of all relevant information in a timely manner that would help them to make well-informed decisions; it certainly would not extend to underwriting any equity risks related to business downturns, and so on. The rule-making role of the regulator and concomitantly its enforcement role thus assume great importance, since there is no greater inducement or encouragement for flouting prescribed rules than the sight of defaulters merrily carrying on regardless of their breach.

It is in this context that SEBI, the Indian regulator, may have to review and step up as necessary its disciplining role and performance. There has to be an even-handed treatment of listed companies in matters of compliance defaults, whether they are in the public sector or in the private sector. For example, it took a very long time for the regulator to question those companies that defaulted on the induction of the prescribed number of independent directors on their boards. Even when SEBI eventually did take up this matter, it was not pursued to its logical conclusion in the case of some of the listed public sector companies (such as the Indian Oil Corporation) where the boards pleaded that it was not in their domain to fill up such positions of independent directors.[11] Shouldn't SEBI, as the guardian of investors and the final arbiter for enforcing its own rules, have the authority to proceed against those in the government who are responsible for making such appointments in time? How else can the interests of the non-government shareholders, in the Indian Oil Corporation Limited for instance, be protected on par with similar shareholders in other listed companies? The larger question that arises under these circumstances is whether SEBI and the stock exchanges should agree to list such companies at all, when it is clear that their boards are disabled from performing some of the essential governance functions in the interests of shareholders.

More instances of such glaring inequities have come to light in the years since good governance rules have been in force, especially in the case of state-owned corporations. For example, in the case of public sector banks that are listed, the annual accounts and directors' reports are tabled at shareholders' meetings for discussion and noting, not for their approval. Such a vital right of shareholders has been completely ignored without the stock exchanges or SEBI taking up the issue with the government for enacting appropriate changes in law. In the absence of such proactive initiatives, the enforcement role of the regulator and stock exchanges would remain not wholly fulfilled. It is also the responsibility of the government—as responsible shareholders—to take stock of the situation and to initiate the steps necessary to restore confidence that its commitment to good corporate governance is fulfilled in letter and spirit, providing a role model that the private sector companies can look up to.

Can stock exchanges contribute to improved corporate governance practices among their listed entities? Stock exchanges historically seem to have been content with falling in line with the requirements “prescribed” either by the government or the capital markets regulator, at least in India. Progressive stock exchanges should go farther than this. Nothing prevents them from laying down listing regulations that improve upon the minimum requirements laid down by the regulator. At the end of the day, stock exchanges also have to build their own reputation to such an extent that being listed on them would be seen as adding reputational value to the companies seeking such a listing. Stricter listing norms would tend to be seen as minimising the governance risks involved in the companies and as such the value of the exchange itself could register favourable gains. There may thus be a good business case for the better stock exchanges to seek and establish unique differentiating points that would stand their valuations in good stead.

4. Summing up

This then is a brief and by no means exhaustive assessment of the corporate governance scenario as we head towards the next decade; the key prescriptions and recommendations for action detailed in this discussion are summarised below.

Key prescriptions and recommendations

On board independence and effectiveness

- Take due note of a director’s association not only with the subject company but with the group entities and related power centres as a whole for purposes of remuneration, in order to determine his/her independence.
- Lay down a progressively diminishing maximum proportion of the board that can be non-executive-non-independent, to pave the way for enhanced board independence.
- Make the communication of the appointment as directors in the name of the board and convey the same to the individual

by the board chair and at least one senior independent director to reinforce allegiance to the company and its shareholders rather than to the CEO or the executive chair in his/her personal capacity.

- Encourage some part of the compensation in the form of equity so as to better align the long term interests of directors and shareholders; lock-in such allocations for the duration of the director's tenure and prohibit trading in such shares during incumbency.
- Materiality of director's compensation should be linked to the individual's income and wealth rather than to the size and earnings of the company.
- Quorum requirements must include the presence of a majority of independent directors on the board and key decisions on specified topics must require the affirmative vote of a majority of the independent directors on the board in totality (and not only of those present at the meeting).
- Set up a quasi-judicial, autonomous National Corporate Governance Authority (NCGA) for transparent peer review by expert panels of uninvolved, experienced directors and other people of eminence, to look at complaints of abuse of power by non-aligned independent directors.
- Appoint independent directors for assured three-year terms; concomitantly, lay down specific ground rules and processes for mid-term dismissal on grounds such as continued absence from board and committee attendance, moral turpitude, criminal convictions even in cases unconnected with the company, observed anti-company activities, etc.
- If resigning mid-term, independent directors should submit their resignations to the shareholders who appointed them. Directors owe it to their members to explain why they were resigning mid-

term and to be personally present (unless circumstances prevent such a course of action) to answer any questions the shareholders may have regarding their resignation.

On shareholder rights and responsibilities

- Greater involvement and contribution should be forthcoming from block holders and institutional investors.
- Institutional investors should transparently communicate to their constituencies their position and voting strategies on key resolutions of their investee companies.
- Some organised structure along the lines of the Council of Institutional Investors in the US or the International Corporate Governance Network in the UK should be considered in order to provide an ever-vigilant and well-informed shareholder review and resistance platform as a possible insurance against recurring corporate misdemeanours.
- When some of the shareholders in the same class are negatively impacted by a decision while others may not be so impacted or may even benefit positively by the decision, mandate that those interested shareholders who stand to benefit do not vote on such resolutions in the members' meetings.
- The compensation committee should be obligated to explain and convince their shareholders that what they recommend as remuneration for managing and executive directors is in the best interests of the company in terms of its value-creating potential.
- Controlling owners and managers should refrain from voting on resolutions relating to their or their representatives' compensation. It should be up to the board, its compensation committees and those shareholders without any interest at stake to decide on such compensation packages.

On gate keeping and regulatory discipline

- Shareholders should not leave the matter of auditors' remuneration to be fixed by the board or audit committee. Practices such as management letters pointing out errors and inadequacies should be addressed to the board/audit committee rather than to executive management. Institutional investors should seriously take up any adverse audit comments and reservations to prevent auditors from being lulled into a false sense of complacency that their reports do not matter to the shareholders, which would then lead to misinformation due to indifference or negligence.
- Self-regulatory measures should be initiated by the profession which would restrict the audits of at least listed companies to audit firms of some prescribed size, experience and expertise.
- Disciplinary functions of the profession may be separated from the training, certifying, and supporting dimensions of professional development.
- Boards/audit committees to determine audit fees based on the value of audit certification rather than on the time spent and costs incurred. For purposes of determining audit independence, the position of the audit firm in relation to its own "group" of associates and affiliates should be considered, domestically as well as internationally, with respect to the importance of the company overall. Ensure that appropriate regulations not only exist but are also enforced in an effective and timely manner.
- Ensure identical treatment of listed companies in matters of compliance defaults, whether they are large or small, in the public sector or in the private sector.
- Stock exchanges should not list those companies where it is clear that their boards are disabled from performing some of the essential governance functions relevant to the protection of minority or absentee shareholders.

- The government should set an example by implementing in letter and spirit best practices in governance in their public sector enterprises.
- Stock exchanges should lay down tougher listing regulations on corporate governance that improve upon the minimum requirements laid down by the regulator.

It is time the country geared up to strengthen its governance practices so as to induce much greater confidence among investors. Some of the directions for change and improvement have been indicated in this paper. Much more of course remains to be done. There are many more miles to go before the country could rest on its laurels of past achievements in this field, significant as they have been by any standards.

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Notes

[1] Incidentally, this is the view that both the Parliament and the Executive in the UK expressed regarding subordinate legislation relating to company law in that country. See Annex A & B (concerning Restatement Powers and Reform Powers respectively) in *Company law: Flexibility and accessibility – A consultative document,* (May 2004), and the House of Commons Trade and Industry Committee's Ninth Report of Session 2003–04, (September 2004) commenting on the *Consultative document* (2004).

[2] A summary of the report and its recommendations are available in Balasubramanian (2010, pp. 567–588).

[3] Vineet Nayyar, Chairman of Mahindra Satyam—the successor company after Mahindra successfully bid and took over Satyam Computers in 2009—believes that this fraud probably had its origins much earlier, maybe in 1992–1994. For details, see Mishra (2010, p. 6).

[4] There is a general rule in Sweden that the shareholders' meeting may not make a decision that might give undue advantage to some shareholders (or to third parties), to the disadvantage of the company or other shareholders. France requires unanimity of votes at a members' meeting in case of some fundamental decisions (Pierce, 2000, p. 232).

[5] Two judicial observations cited in the Hong Kong committee report on company law reforms (Hong Kong, 2000) are worthy of recall in this context:

> [T]he result of counting votes of the interested directors is to render the consent process useless in those cases in which the directors are able to affect the outcome. It becomes a pointless formality, inevitably producing the same result as the original board decision. Instead of the directors being required to satisfy an independent body within the company that the transaction is fair, the onus is thrown back onto an objecting shareholder to demonstrate to the court that it is unfair, the problems associated with which the fiduciary principle is expressly designed to avoid.
>
> (From: Parkinson, 1993, p. 216.)
>
> Ordinarily the director speaks for and determines the policy of the corporation. When the majority of stockholders do this, they are, for the moment, the corporation. Unless the majority in such case[s] are to be regarded as owing a duty to the minority such is owed by the directors to all, then the minority are in a situation that exposes them to the grossest of frauds.
>
> (From: *Greene Vs Dunhill International, Inc*, 249 A 2d 427 at 432 – Del.Ch.1968.)

[6] For a contrary view which maintains that financial sector compensations have largely been no worse but in fact have been the same or even better than compensations in the non-financial sector, see Adams (2009).

[7] The 2010 provisions of the Dodd-Frank financial sector reforms legislation and the earlier SEC requirements for a Compensation Discussion and Analysis report in the US, and the Walker Report recommendations in the UK are illustrative of the increasing governmental interventions in corporate executive compensation issues.

[8] Jensen and Murphy (2004) had a total of 38 such recommendations to offer in this paper, most of which are still very relevant internationally and most appropriate to Indian circumstances. Among them are an admonition to eschew the use of compensation consultants, and if unavoidable, to ensure they are appointed by and report to the committee rather than to executive management; they also highlight the imperative to change the structural, social, and psychological environment of the board so that the directors do not see themselves as obligated to or effectively employed by the CEO.

[9] Among the reasons supporting this conclusion was the finding that people tend to be less concerned about harming a statistical victim (remote population of shareholders) than a known victim (identifiable executive management). Other factors that were taken into consideration were the immediate adverse consequences of a negative opinion on an audit (possible loss of contract or employment); long-standing relationships with the companies under audit (familiarity); lax reporting standards and monitoring; and easy rationalisation of trade-offs (people at large may not actually be affected by misinformation, and hence it does not matter).

[10] The virtual disowning of the local firm and concerned partners by the global firm management in the Satyam episode opens up an interesting question as to whether the HQ approach would have been different had it been the Indian outfit of an international client instead of an isolated Indian client like Satyam.

[11] See Order under section 23 I of Securities Contracts (Regulation) Act, 1956, read in conjunction with Rule 4 of Securities Contracts (Regulation) (Procedure for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules, 2005, in the context of the Adjudication Proceedings against Indian Oil Corporation Limited. Adjudication Order No. BS/AO-60/2008, dated 27 October, 2008.