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CORPORATE GOVERNANCE

AND THE EMPOWERMENT OF THE INVESTORS

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Abstract

The paper is divided into three sections. The first section discusses certain theoretical issues on corporate governance in relation to empowerment of shareholders and argues why corporate governance is essentially a tool for investor protection; it also argues why some of the commonly used systems of corporate governance are necessary. The second section, surveys corporate governance across major markets of the world. The third section reports on the recent initiatives on corporate governance in India by the Securities and Exchange Board of India – the appointment of the Birla Committee and implementations of the recommendations. It discusses the rationale of each recommendation as in the original report. As would be seen the recommendations find justification in the theoretical foundations of corporate governance discussed in the first section and also favorably compare with the codes, guidelines and laws on corporate governance in developed markets.

The views expressed in this paper are author's own and does not necessarily reflect the views of the Securities and Exchange Board of India.

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CORPORATE GOVERNANCE AND THE EMPOWERMENT OF THE INVESTORS

Section 1

Corporate Governance and Shareholder Protection – Theoretical Issues

Introduction

1.1 In third century B. C., in the city of Pataliputra, Kautilya wrote his celebrated treatise on statecraft – Arthasastra. History records Pataliputra, as a city "astonishingly well organised and administered according to best principles of governance". It was the capital of the Mauryan Empire – and Kautilya was its crafty vizier, virtually holding in his hands the directions of the government. It was then the classical age of India, - when thought flowed with secular independence, and the free mind flowered with creative exuberance. In that environment, with unbridled and emancipated rationality, tempered with delicate realism, Kautilya preserved in this book his precepts of the social, political and economic structure of an ideal state. The purpose this paper however is not to critique Arthasastra, nor merely to draw parallels between Arthasastra and subject of this paper, but to pluck a few ideas relevant to the subject, as an illustration of their enduring validity. The ideas chronicled and contemplated in the treatise appeal to the modern intellect, as they essentially view state as an economic entity, an experiment on an economic organisation which is preserved by governance and government, and passes through the mutations of morals and manners, customs and traditions, aspirations and beliefs.

1.2 Writing about the ideal conduct of the king, Kautilya says an ideal king is one for whom

> *"Praja sukhe, sukham ragyam,*
> *Prajanan ca hite hitam,*
> *Naatman priyam hitam ragyan,*
> *Parajanan tu priyam hitam".*
>
> *(Arthasastra: Book 1 chapter19, verse 36)*
> *(Language Sanskrit)*
>
> *"in the happiness and wellbeing of the subjects, lies the well being of the king,*
> *in the welfare of the subjects, is the welfare of the king,*
> *what is desirable and beneficial to the subjects*
> *and not his personal desires and ambitious is desirable and beneficial to the king."*
>
> *(English Translation)*

Kautilya further elaborates on the fourfold duty of a king as –

- *raksha*, or protection
- *vridhi*, or enhancement
- *palana* or maintenance
- *yogakshema* or safeguard

1.3 The substitution of the state with the corporation, the king with the CEO or the board of a corporation, and the subjects with the shareholders, bring out the quintessence of corporate governance, because central to the concept of corporate governance is the belief that public good should be ahead of private good; and that the corporation's resources cannot be used for personal benefit. The fourfold duties of the king can be interpreted to imply protecting the shareholders wealth, enhancing the wealth through proper utilisation of assets, maintenance of that wealth and not frittering away in unconnected and non profitable ventures or through expropriation, and above all safeguarding the interests of the shareholders. In other words as near an alignment as possible is sought between the interests of individuals, corporations and society. The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for states is to strengthen their economics and discourage fraud and mismanagement. A little extrapolation of the argument leads to the conclusion that providers of the firm's capital, mangers have a responsibility to use assets efficiently in the pursuit of the firm's objective. The fundamental concern of corporate governance is to ensure the means by which a firm's managers are held accountable to capital providers for the use of the assets.

1.4 Studies of firms have shown that markets and investors take notice of well-managed companies, respond positively to them, and reward such companies, with higher valuations. A common feature of such companies is that they have systems in place, which allow sufficient freedom to the boards and management to take decisions towards the progress of their companies and to innovate, while remaining within a framework of effective accountability. In other words they have a system of good corporate governance.

1.5 Focus on corporate governance and related issues is an inevitable outcome of a process, which leads firms to increasingly shift to financial markets as the pre-eminent source for capital. In the process, more and more people are recognizing that corporate governance is indispensable to effective market discipline. This growing consensus is both an enlightened and a realistic view. In an age where capital flows worldwide, just as quickly as information, a company that does not promote a culture of strong, independent oversight, risks its very stability and future health. As a result, the link between a company's management, directors and its financial reporting system has never been more crucial. As the boards provide stewardship of companies, they play a significant role in their efficient functioning.

1.6 Strong corporate governance is thus indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high-quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure. Without financial reporting premised on sound, honest numbers, capital markets will collapse upon themselves. It is therefore almost a truism that the adequacy and the quality of corporate governance shape the growth and the future of any capital market and economy.

1.7 Another important aspect of corporate governance relates to issues of insider trading. It is important that insiders do not use their position of knowledge and access to inside information about the company, and take unfair advantage of the resulting information asymmetry. To prevent this from happening, corporates are expected to disseminate the material price sensitive information in a timely and proper manner and also ensure that till such information is made public, insiders abstain from transacting in the securities of the company. The principle should be ‘disclose or desist’. This therefore calls for companies to devise an internal procedure for adequate and timely disclosures, reporting requirements, confidentiality norms, code of conduct and specific rules for the conduct of its directors and employees and other insiders. For example, in many countries, there are rules for reporting of transactions by directors and other senior executives of companies, as well as for a report on their holdings, activity in their own shares and net year to year changes to these in the annual report. The rules also cover the dealing in the securities of their companies by the insiders, especially directors and other senior executives, during sensitive reporting seasons. However, the need for such procedures, reporting requirements and rules also goes beyond corporates to other entities in the financial markets such as Stock Exchanges, Intermediaries, Financial institutions, Mutual Funds and concerned professionals who may have access to inside information. This aspect also needs to be dealt in a comprehensive manner.

1.8 Securities market regulators in almost all developed and emerging markets have for sometime been concerned about the importance of the subject and of the need to raise the standards of corporate governance. The financial crisis in the Asian markets in the recent past have highlighted the need for improved level of corporate governance and the lack of it in certain countries have been mentioned as one of the causes of the crisis. Besides in an environment, in which emerging markets increasingly compete for global capital, it is evident that global capital will flow to markets which are better regulated and observe higher standards of transparency, efficiency and integrity. Raising standards of corporate governance is therefore also extremely relevant in this context.

1.9 This is well brought out in its statement of *Global Corporate Core Principles & Guidelines* by the California Public Employees Retirement System (CalPERS). CalPERS with its assets in excess of US $110 billion, brought out this statement in the light of its increasing international investments. CalPERS believes "good" corporate governance leads to improved long-term performance. CalPERS also strongly believes that "good" governance requires the attention and dedication not only of a company's officers and directors, but also its owners. While being aware that all companies under a structure of full accountability or not - will inevitably experience both ascents and descents along the path of profitability, CalPERS defines good corporate governance – that is, accountable corporate governance – as the difference between wallowing for long (and perhaps fatal) periods in the depths of the performance cycle, and responding quickly to correct the corporate course.

The Shareholder Perspective

1.10 Corporate governance has several claimants –shareholders and other stakeholders - which include suppliers, customers, creditors, the bankers, and the employees of the company, the government and the society at large. But for good reasons it could be discussed keeping in view primarily the interests of a particular class of stakeholders, namely, the shareholders. This paper looks at corporate governance from the perspective of the shareholders and investors, because they are the raison de etre for corporate governance. The control and reporting functions of boards, the roles of the various committees of the board, the role of management, all assume special significance when viewed from this perspective. The other way of looking at corporate governance is from the contribution that good corporate governance makes to the efficiency of a business enterprise, to the creation of wealth and to the country's economy. In a sense both these points of view are related and evidence suggests that there is a clear convergence of both points of view.

1.11 It could then be agreed that the fundamental objective of corporate governance is the enhancement of shareholder value**,** keeping in view the interests of other stakeholder. This definition harmonises the need for a company to strike a balance at all times between the need to enhance shareholders' wealth whilst not in any way being detrimental to the interests of the other stakeholders in the company.

1.12 But the imperative for corporate governance lies not merely in drafting a code of corporate governance, but in practising it. Structures and rules are important because they provide a framework, which will encourage and enforce good governance; but alone, these cannot raise the standards of corporate governance. What counts is the way in which these are put to use. The best results would be achieved when the companies themselves begin to treat appropriate codes not as mere structures, but as a way of life.

1.13 It follows that the real onus of achieving the desired level of corporate governance, thus always lies in the proactive initiatives taken by the companies themselves and not in the external measures like breadth and depth of a code or stringency of enforcement of norms. The extent of discipline, transparency and fairness, and the willingness shown by the companies themselves in implementing the standards of corporate governance are the factors crucial in achieving the desired confidence of shareholders and other stakeholders and fulfilling the goals of the company. At the same time the mechanisms of investor protection should be such as to allow the flow of capital and the market to grow and allocate resources efficiently.

Shareholder Empowerment through Corporate Governance

1.14 One reason why corporate governance should be looked from the point of view of the shareholders and hence can be an effective tool for their empowerment is that corporate governance through systems, laws and rules, essentially deals with ways "in which the suppliers of finance to corporations assure themselves of getting a return on their investment i.e. some profits the can get back". This is often an issue because the suppliers are not managers of finance and there might well be the possibility of the managers of finance absconding or misusing the money. The shareholders as investors are one of the major suppliers of finance and as equity partners also owners of the corporation. There clearly is a need for economic and legal institutions for protecting them from such misuse.

Product market competition versus corporate governance

1.15 There is one school of thought, at least in India and perhaps in some of the developed markets as well that places excessive faith on the power of markets and hence on competition as the agent of change. If this be so, runs the argument, competition should take care of corporate governance. To illustrate their point they cite cases where market has given its pronouncements with voting with the dollars and the consequential plummeting of share price after a certain action is taken by the managers. Acquisition announcements often meet with this fate. The counterfactual is that to acknowledge that that product market competition is probably the most powerful force toward economic efficiency in the world is not to deny the place for the mechanisms for corporate governance. Competition may govern the flow of capital and even control the flow but it cannot alone solve the problem of corporate governance, as it may not prevent expropriation of funds by the managers. There is also the possibility of self-dealing by the managers, which in want of systems may not protect the shareholders. Hence systems for corporate governance are required for empowering the shareholder.

Managerial expropriation

1.16 There are various forms of managerial expropriation, “such as transfer pricing –in Russia the oil sales often take place to manager owned trading companies; in the case of Korea chaebols have in the past sold the subsidiaries to the relatives; or as in Italy one state controlled sold assets to another at a very high price”. But the easiest and costliest of the expropriations are the perquisites. Often expropriation takes the form of expansion of corporations beyond requirement or takeovers. Incentive contracts are looked with suspicion. Diversification and growth are amongst the most commonly cited activities, which displays the dominance of dominance of managerial than shareholder motives. Kaplan and Weisbach (1992) have documented the poor history of diversification of the US firms and the common incidence of subsequent divestitures. “Hence the need of the systems to constrain the managers from pursuing personal agenda this reduces ex poste misallocation to allow funds ex ante”. As a first step it is important to know about the existence of such expropriations. This is brought about through accounting and auditing requirements such as disclosure of related party transactions, disclosures in annual reports of salaries, and perquisites for the management, which are the easiest and costliest of all expropriations and above all through the fidelity of the accounts itself. In addition, good corporate governance mechanisms require an active market for corporate control as well as legal systems which allow full disclosures to the shareholders and their participation in the process.

Corporate governance and the agency perspective

1.17 It is common to look at corporate governance from an agency perspective i.e. separation of ownership and control. Even from this perspective corporate governance is an instrument of shareholder protection.

Risks in capital raising

1.18 Very often when a collection of money takes place from a large body of investors, as in the case of any public issue of capital, they are too small and poorly informed to exercise even the control rights they actually have. The free rider problem faced by the existing investor makes it uninteresting for him to learn about the firms they have financed or even participate in the governance, in the same way as citizens are unlikely to make efforts on their own to get informed about the political candidates and vote. This makes it imperative for legal systems and requirements to be in place to ensure that the small investors are protected. Corporate governance enables this to happen and thus empowers the investors. Usually the problem enunciated above is addressed through mandatory disclosures and voting rights and also easily accessible systems, which enable individuals to exercise their voting rights. It is clear from the above discussions that disclosure is an important instrument of corporate governance and shareholder protection.

Why investors tend to invest blindly

1.19 Financing without governance can be dangerous. There is enough theory and evidence to suggest that investors do part with their money and give it to the managers though the investors are aware at the time they part with their money that the managers have enormous discretion about what is done with that money, often to the point of being able to expropriate much of it. However intriguing the question may be, it is true. Studies usually attribute this behaviour to excessive investor optimism, which is the euphemism for avarice and reputation of the managers of providing adequate returns in the past. The success of the pyramid schemes and Ponzi schemes are predicated on these reasons. The enormous volume of the equity financing into the new economy stocks is an evidence of the investor optimism which is blind and overlook the non availability of mechanisms that can force managers to repay the investors. Some of the examples of investor optimism are systematic overvaluation of the shares of the companies issuing equity in initial and secondary offerings, and the decline of profitability and share price following the issue; concentration of new issues when the stock markets are high, earnings manipulation prior to issue. Under such situations it is important that economic and legal institutions exist to empower the shareholders. Corporate governance systems are the foundations of such institutions.

External financing and legal protection

1.20 Recent research on corporate governance around the world has established a number of empirical regularities. Such diverse elements of countries' financial systems as breadth and depth of their capital markets, the pace of new security issues, corporate ownership structures, dividend policies, and the efficiency of investment allocation appear to be explained both conceptually and empirically by how well the laws in these countries protect outside investors. According to this research, the protection of shareholders and creditors by the legal system is central to understanding the patterns of corporate finance in different countries.(La Porta, Silanes, Shleifer, Vishney, 1999)

1.21 External financing give contractual rights to the financiers of the corporation on the assets of the firm. Much of the differences in the corporate governance systems around the world stem form the differences in the nature of the legal obligations that the managers have to the financiers and how these are enforced. Recent research suggests that where laws are protective of outside investors and well enforced, investors are willing to finance firms, and financial markets are both broader and more valuable. In contrast, where laws are unprotective of the rights, [or if those rights do not even exist in the first place], the development of financial markets is stunted. When the rights are better protected by the law the investors are willing to pay more for financial assets such as equity and debt. They pay more because they recognise that with better protection, more of firm's profits would come back to them as interests or dividend and not be expropriated. (La Porta et al.)

1.22 Important among these rights is the right to vote on important corporate matters. But voting rights may turn out to be expensive; the requirement may be such that the shareholders may not be able to vote unless they are personally present, and electronic voting may not be permitted; in such cases the managements may hold the general body meetings at inconvenient places and times making it difficult for the shareholders to attend. Under such situations shareholders rights may be easily violated.

1.23 Second the structure of the board, which is elected by the shareholders. Hence important know the structure of the boards. These vary greatly even across developed economies, ranging from two tier supervisory and management boards as in Germany, to insider dominated boards in Japan, to mixed boards in the United States. The question of the effectiveness of the boards in any of these countries proved to be controversial. The available systematic evidence is mixed. In the US the boards especially those dominated by the outside directors, sometimes remove top managers after poor performance (Weisbach 1988). However a true performance disaster is required before boards actually act and the boards are generally passive except under extreme circumstances. Mace (1971) and Jansen(1993) argue that as general rule the corporate boards are captured by the management. But what is more important that the shareholders have sufficient information about the directors who offer themselves for election and mechanism exists to enable them to obtain this information. (Schleifer and Vishney, 1996).

Affirmative duty of loyalty

1.24 "In many countries the shareholders voting rights are supplemented by an affirmative duty of loyalty of the managers towards the shareholders. Loosely speaking the managers are required to act in shareholders' interest. The appropriateness of this duty is often challenged by those who believe that managers have a duty of loyalty to employees, communities, creditors, the state, and so on. The courts in the OECD countries have generally accepted the idea of manager's duty to the shareholders for good reason. The investments of the shareholders are generally sunk and is one time and because they are sunk they have fewer protections from expropriation than other stakeholders. To induce them to invest more they need stronger protection, such as the duty of loyalty." (Schleifer and Vishney, 1996).

1.25 The commonly accepted element of the duty of loyalty are -legal restrictions on managerial self dealing, such as the outright theft from the firm, excessive compensation, issues of additional equity to the management and its relatives. In some countries the laws explicitly prohibits self-dealing; in others the courts enforce corporate charters. Some legal restrictions curtail the freedom of the managers requiring that they consult the boards. The US is generally viewed to be tough on the duty of loyalty – class action suits can be brought up. This concept is much weaker in several countries outside the US and the OECD (Schleifer and Vishney, 1996).

1.26 The discussions in the foregoing paragraphs bring out why the corporate governance systems must embody certain mechanisms including legal and economic institutions to protect the shareholders and how these mechanisms and institutions can effectively empower the shareholders. In the next section, the corporate governance systems in various countries would be examined.

Section 2

Survey of Corporate Governance Systems

Introduction

2.1 Over the past five years or so there has been a growing recognition that a firm's corporate governance affects both its economic performance and its ability to access patient, low-cost capital. The board of directors in a unitary system or, the supervisory board in two-tier systems, - has a key role in ensuring that managers are accountable to capital providers for the use of firm assets. Although boards of directors provide an important internal mechanism for holding management accountable, effective corporate governance is supported by and dependent on the market for corporate control, securities regulation, company law, accounting and auditing standards, bankruptcy laws, and judicial enforcement. There has thus been a proliferation of corporate governance guidelines and codes of "best practice" designed to improve the ability of corporate directors to hold managements accountable. These codes, guidelines, stock exchange listing requirements, all of which could be collectively called as corporate governance instruments for the sake of convenience, have certain common elements. All of them emphasise that boards have responsibilities separate and apart from management; all enumerate the practices that should best enable directors to carry out these responsibilities.

2.2 Differences in national frameworks of law, variations in the market practices and regulation of the stock exchanges, differing societal values explain the variations in the corporate governance instruments. Therefore, to understand one nation's corporate governance practices in relation to another's, one must understand not only the "best practice" documents but also the underlying legal and enforcement framework.

2.3 Some governance codes are linked to listing or legally mandated disclosure requirements. Others are purely voluntary in nature -- but may be designed to help forestall further government or listing body regulation. In the developing nations, governance codes are more likely to address basic principles of corporate governance that tend to be more established in developed countries through company law and securities regulation, such as the equitable treatment of shareholders, the need for reliable and timely disclosure of information concerning corporate performance and ownership, and the holding of annual general meetings of shareholders. However, in both developed and developing nations, codes focus on boards of directors and attempt to describe ways in which boards can be positioned to provide some form of guidance and oversight to management, and accountability to shareholders and society at large.

Overview

2.4 The modern trend of developing corporate governance guidelines and codes of best practice began in the early 1990's in the United Kingdom, the United States and Canada in response to problems in the corporate performance of leading companies, the perceived lack of effective board oversight that contributed to those performance problems, and pressure for change from institutional investors. The Cadbury Report in the U.K., the General Motors Board of Directors Guidelines in the U.S., and the Dey Report in Canada have each proved influential sources for other guideline and code efforts.

2.5 Over the past decade, governance guidelines and codes have issued from stock exchanges, corporations, institutional investors, and associations of directors and corporate managers. Compliance with these governance recommendations is generally not mandated by law, although the codes linked to stock exchanges may have a coercive effect. For example, listed companies on the London and Toronto Stock Exchanges need not follow the recommendations of the Cadbury Report (as amended in the Combined Code) and the Dey Report, but they must disclose whether they follow the recommendations in those documents and must provide an explanation concerning divergent practices. Such disclosure requirements exert a significant pressure for compliance. In contrast, the guidelines issued by associations of directors, corporate managers and individual companies tend to be wholly voluntary. For example, the GM Board Guidelines simply reflect an individual board's efforts to improve its own governance capacity. Such guidelines can have wide influence, however. For example, in the case of the GM Guidelines, institutional investors encouraged other companies to adopt similar guidelines.

2.6 In developing nations, both voluntary guidelines and more coercive codes of best practice have issued as well. For example, both the Code of Best Practices issued by the Brazilian Institute of Corporate Directors and the Code of Corporate Governance issued by the Corporate Governance Committee of the Mexican Business Coordinating Counsel are wholly aspirational and not linked to any listing requirements. Similarly, the Stock Exchange of Thailand Code are designed to build awareness within the corporate sector of governance best practice, but are not, at this time, linked to stock exchange listing requirements. In contrast, Malaysia's Code on Corporate Governance, the Code of Best Practice issued by the Hong Kong Stock Exchange, and South Africa's King Commission Report on Corporate Governance, all contemplate mandatory disclosure concerning compliance with their recommendations.

2.7 Some of the key elements of governance guidelines and codes of best practice, particularly as issued in developing nations, are summarized below:

The Corporate Objective

2.8 Variations in societal values lead different nations to view the corporate objective or "mission" distinctly. Expectations of how the corporation should prioritize the interests of shareholders and stakeholders such as employees, creditors and other constituents take two primary forms. In the Anglo-Saxon nations -- Australia, Canada, the U.K., and U.S. -- maximizing the value of the owners' investment is considered the primary corporate objective. This objective is reflected in governance guidelines and codes that emphasize the duty of the board to represent shareholders' interests and maximize shareholder value. Among developing nations, the Brazilian Institute of Corporate Governance Code, the Confederation of Indian Industry Code, the Kyrgyz Republic Charter of a Shareholding Society, and the Malaysian Report on Corporate Governance, all expressly recognize that the board's mission is to protect and enhance the shareholders' investment.

> *The mission of the board of directors is to maximize shareholder value.*
> Brazilian Institute of Corporate Governance Code of Best Practice at 1.
>
> *The Board of Directors represents the shareholders of the Society, and it has a duty to act in the interests of the shareholders.*
> Charter of a Shareholding Society (Kyrgyz Republic)
>
> *The single overriding objective [of] all listed companies . . . is the preservation and enhancement over time of their shareholders' investment.*
> Report on Corporate Governance (Malaysia)

2.9 In other countries, more emphasis is placed on a broader range of stakeholders. However, this view is not strongly advocated in the governance guidelines and codes emanating from developing nations, although some documents recognize that stakeholder interests should be considered. (For example, the King Report from South Africa states: "Directors must act with enterprise and always strive to increase shareholders' value while having regard for the interests of all stakeholders." This may be due to a convergence in perceptions about the corporate objective. There is a growing recognition that shareholder expectations need to be met in order to attract patient, low-cost capital. Likewise, there is growing sensitivity to the need to address stakeholder interests in order to maximize shareholder value over the long term. As the General Motors Board of Directors Mission Statement recognizes, "the board's responsibilities to shareholders as well as customers, employees, suppliers and the communities in which the corporation operates are all founded upon the successful perpetuation of the business." Simply put, shareholder and stakeholder interests in the success of the corporation are compatible in the long run.

Board Responsibilities

2.10 Most governance guidelines and codes of best practice assert that the board assumes responsibility for the stewardship of the corporation and emphasize that board responsibilities are distinct from management responsibilities. However, the guidelines and codes differ in the level of specificity with which they explain the board's role. For example, Canada's Dey Report, France's Vienot Report, Malaysia’s Report on Corporate Governance, Mexico’s Code of Corporate Governance and South Africa's King Report all specify board functions such as strategic planning; risk identification and management; selection, oversight and compensation of senior management; succession planning; communication with shareholders; integrity of financial controls; and general legal compliance, as distinct board functions. The Kyrgyz Republic Charter sets out a detailed list of matters requiring board approval. Other governance guidelines and codes of best practice are far less specific. For example, the Hong Kong Stock Exchange Code simply refers to directors' obligations to ensure compliance with listing rules as well as with the "declaration and undertaking" that directors are required to execute and lodge with the Exchange. The different approaches among codes on this point likely reflect variations in the degree to which company law or listing standards specify board responsibilities, rather than any significant substantive differences.

The main functions of a board are :
- *to direct the company both as to strategy and structure;*
- *to establish from time to time a strategy for the company, including a determination of the businesses that the company should be in and those that it should not be in;*
- *to ensure that the executive management implements the company's strategy as established from time to time;*
- *to ensure that the company has adequate systems of internal controls both operational and financial;*
- *to monitor the activities of the executive management;*
- *to select the chief executive, ensure succession and give guidance on the appointment of senior executives;*
- *to provide information on the activities of the company to those entitled to it;*
- *to ensure that the company operates ethically;*
- *to provide for succession of senior management;*
- *to address the adequacy of retirement and health care benefits and funding.*

The King Report (South Africa)

Board Composition

2.11 Most governance guidelines and codes of best practice address topics related to board composition including: director qualifications/membership criteria; the director nomination process; and board independence and leadership.

2.12 *Criteria.* The quality, experience and independence of a board's membership directly affect board performance. Board membership criteria are described by various guidelines and codes with different levels of specificity, but tend to highlight issues such as experience, personal characteristics (including independence), core code competencies and availability.

Every non-executive director must ensure that he can give sufficient time and attention to the affairs of the issuer and satisfy the Exchange that he has the character, integrity, experience and competency to serve as a director of a listed company.
The Hong Kong Stock Exchange Code, Code of Best Practice and Guideline

The board should have a diversity of background, knowledge and experience.
The Brazilian Institute of Corporate Governance Code of Best Practice .

[A] candidate should have integrity and independence of thought; the courage to express their independent thought; a grasp of the realities of business operations; an understanding of the changes taking place regionally, nationally and internationally; [and] an understanding of business and financial "language."
The King Report (South Africa)

2.13 *Director Nomination*. The process by which directors are nominated has gained attention in many guidelines and codes, which tend to emphasize a formal and transparent process for appointing new directors. The use of nominating committees is favored in the U.S. and U.K. as a means of reducing the CEO's influence in choosing the board that is charged with monitoring his or her performance. (See, in the U.S., the Report of the National Association of Corporate Directors Commission on Director Professionalism (1996), and the General Motors Board of Directors Guidelines (1994); in the U.K., the Hampel Committee Report (1998)). The Malaysian Corporate Governance Report expresses a similar view: “[T]he adoption of a formal procedure for appointments to the board, with a nomination committee making recommendations to the full board, should be recognized as good practice.” At the same time, however -- and as advocated by the King Report (South Africa) -- it is generally agreed that the board as a whole has the ultimate responsibility for nominating directors.

2.14 *Mix of Inside and Outside or "Independent" Directors*. Most governance guidelines and codes of best practice agree that some degree of director independence - or the ability to exercise objective judgment of management's performance - is important to a board's ability to exercise objective judgment concerning management performance. In the U.S., U.K., Canada and Australia, although not required by law or listing requirements, best practice recommendations generally agree that boards of publicly traded corporations should include at least some independent directors. This viewpoint is the furthest developed in the U.S. and Canada, where best practice documents call for a "substantial" majority of the board to be comprised of independent directors. Elsewhere best practice recommendations are somewhat less stringent and seek to have a balance of executives and non-executives, with the non-executives including some truly independent directors. (Although "non-management" or "non-executive" directors may be more likely to be objective than members of management, many code documents recognize that a non-management director may still not be truly "independent" if he or she has significant financial or personal ties to management.) Nonetheless, a general consensus is developing throughout a number of countries that public company boards should include at least some non-executive members who lack significant family and business relationships with management.

The majority of the board members should be independent.
Brazilian Institute of Corporate Governance Code of Best Practice

No board should have less than two non-executive directors of sufficient calibre that their views will carry significant weight in board decisions.
The King Report (South Africa)

[I]t is recommended that Independent Directors represent at least 20% of the total number of Board members.
Mexico Code of Corporate Governance

2.15 Definitions of "independence" vary. For example, according to the Brazilian Institute of Corporate Governance, a director is independent if he or she: has no link to the company besides board membership and share ownership and receives no compensation from the company other than director remuneration or shareholder dividends; has never been an employee of the company (or of an affiliate or subsidiary); provides no services or products to the company (and is not employed by a firm providing major services or products); and is not a close relative of any officer, manager or controlling shareholder.

Every listed company should have independent directors, i.e., directors that are not officers of the company; who are neither related to its officers nor represent concentrated or family holdings of its shares; who, in the view of the company's board of directors, represent the interests of public shareholders, and are free of any relationship that would interfere with the exercise of independent judgment."
Malaysian Report on Corporate Governance

In February 1998, the Korea Stock Exchange adopted a listing requirement that will mandate that outside directors soon comprise at least a quarter of the board of every listed company. Included among the list of persons who do not qualify as "outside directors" are: controlling shareholders; a spouse or family member of a director who is not an outsider; current or recent officers and employees of the corporation, its affiliates, or of corporations that have "important business relations" with the corporation; and persons who serve as outside directors on three or more listed companies.
KSE Listing Regulation.

2.16 In comparison, the Cadbury Code simply refers to directors who - apart from their fees and shareholdings -- are independent from management and free from any business or other relationship which could materially interfere with the exercise of independent judgment. And many of the best practice documents - such as the Cadbury Report and the National Association of Corporate Directors Report on Director Professionalism (U.S.) - view the ultimate determination of just what constitutes "independence" to be an issue for the board itself to determine.

2.17 Independent Board Leadership. Independent board leadership is thought by some to encourage the non-executive directors' ability to work together to provide true oversight of management. As explained by the National Association of Corporate Directors (U.S.): "the purpose of creating [an independent] leader is not to add another layer of power but to ensure organization of, and accountability for, the thoughtful execution of certain critical independent functions" - such as evaluating the CEO; chairing sessions of the non-executive directors; setting the board agenda; and leading the board in responding to crisis.

2.18 Many guidelines and codes seek to institute independent leadership by recommending a clear division of responsibilities between Chairman and CEO. In this way, while the CEO can have a significant presence on the board, the non-executive directors will also have a formal independent leader to look to for authority on the board. Documents that place less emphasis on the need for a majority of independent directors seem to place more emphasis on the need for separating the role of Chairman and CEO. For example, the Indian Confederation Report expressly relates the two concepts - recommending that if the Chairman and CEO (or managing director) are the same person, a greater percentage of non-executive directors is necessary. The Malaysian Report on Corporate Governance similarly emphasizes that “[w]here the roles are combined there should be a strong independent element on the board.” This is in accord with the Cadbury Report, which states that, where the Chairman is also the CEO "it is essential that there should be a strong and independent element on the board."

Board Committees

2.l9 In developed nations, it is fairly well accepted that many board functions are carried out by board committees. For example, a *nominating committee*, an *audit committee* and a *remuneration committee* are recommended in Australia, Belgium, France, Japan, the Netherlands, Sweden, United Kingdom and the United States. While composition of these committees varies, it is generally recognized that non-executive directors have a special role.

2.20 The functioning and composition of the audit committee receives significant attention in most guideline and code documents because of the key role it plays in protecting shareholder interests and promoting investor confidence.

Special emphasis has been placed on the need for all listed company boards to establish audit committees to ensure the effective and efficient control and review of a company's administration, internal audit procedures, the preparation of financial statements and the general disclosure of material information to investors and shareholders.
President's Message, Stock Exchange of Thailand Code and Guidelines

[There should be] a mechanism that lends support to the Board in verifying compliance of the audit function, assuring that internal and external audits are performed with the highest objectivity possible and that the financial information is useful, trustworthy and accurate.
Mexico Code of Corporate Governance

2.21 Certain countries specifically recommend the size of an audit committee. In Malaysia the minimum size recommended is three members, as it is in and the United Kingdom. South Africa emphasises the extra time requirements demanded of audit committee members, and the importance of written terms of reference for this committee. Malaysia also refers to the need for written terms of reference for audit and other board committees.

Disclosure Issues

2.22 Disclosure is an issue that is highly regulated under securities laws of many nations. However, there is room for voluntary disclosure by companies beyond what is mandated by law. Most countries generally agree on the need for directors to disclose their own relevant interests and to disclose financial performance in an annual report to shareholders. Generally this is required by law, but some guidelines and best practice documents address it as well. Similarly, even though directors are usually subject to legal requirements concerning the accuracy of disclosed information, a number of codes from both developed and developing nations describe the board's responsibility to disclose accurate information about the financial performance of the company, as well as information about agenda items, prior to the annual general meeting of shareholders. (Many codes also itemize the issues reserved for shareholder decision at the AGM.) Generally, guidelines and codes of best practice place heavy emphasis on the financial reporting obligations of the board, as well as board oversight of the audit function. Again, this is because these are key to investor confidence and the integrity of markets. South Africa lays out the key points that the directors must comment on, whereas other countries do not go to this level of detail, but the distinction is not necessarily substantive since disclosure tends to be heavily regulated in many nations through securities laws.

2.23 This brief review of the primary principles addressed by various guidelines and codes indicates that there is no single agreed upon system of "good" governance. Each country has its own corporate culture, national personality and priorities. Likewise, each company has its own history, culture, goals and business cycle maturity. All of these factors need to be taken into consideration in crafting the optimal governance structure and practices for any country or any company. However, the influence of international capital markets will likely lead to some convergence of governance practices.

> *As regulatory barriers between national economies fall and global competition for capital increases, investment capital will follow the path to those corporations that have adopted efficient governance standards, which include acceptable accounting and disclosure standards, satisfactory investor protections and board practices designed to provide independent, accountable oversight of managers.*
>
> Report to the OECD by the Business Sector Advisory Group on Corporate Governance (April 1998) (the Millstein Report).

2.24 This convergence is evident in the growing consensus in both developed and developing nations that board structure and practice is key to providing corporate accountability -- of the management to the board and the board to the shareholders -- in the governance paradigm.

2.25 The discussions in the foregoing paragraphs set the theoretical perspective and provide a set of international comparators against which the initiatives taken by India for strengthening the systems of corporate governance could examined in the next section.

Section 3

Corporate Governance Initiatives in India

Introduction

3.1 Although the subject of corporate governance has been receiving explicit attention in India only in the last few years, unlike in the emerging market and transition economies, the institutional and regulatory framework for corporate framework have been in place for a long time. The legal framework for regulating all corporate activities including governance and administration of companies, disclosures, shareholders' rights, – i.e. the Companies Act has been in place since 1956 and has been fairly stable. The stock exchanges have been executing listing agreements laying down on-going conditions and continuous obligations for companies. Indeed, by Aoki's classification (1995), "India could be considered to be in the "post-transition regime" with well defined and stable corporate governance structure, and where the management of enterprises is chosen through due process defined by the corporate law. India is also representative of many developing countries in terms of its reliance on external sources of finance as well as the prevalence of insider-dominated family business".

3.2 But over the past few years greater attention is being focussed on the subject and there has been a discernible growth in the awareness about corporate governance being an intrinsic part of companies' best practices and obligations. Lack of it, or, inadequacy of corporate governance among companies, has been featuring in the media, in the board rooms of financial institutions who are the block holders in many companies, and in academic debates as one of the reasons for the "present disenchantment" of small investors. The boards of enlightened companies - even those belonging to the business families – financial institutions and other large institutional shareholders, investors and regulators are increasingly becoming aware of the need for disclosures, open and transparent management concepts, continuing obligation to put out material information, better accounting standards, and for setting out standards of best practices to be pursued by the directors, managers and employees of companies. Protection of shareholder's interest and preservation and enhancement of shareholder value and wealth are concepts, which are being widely recognised in the industry and assuming greater importance.

3.3 Several factors have helped drive this change. *First*, the economic reforms which have allowed the growth of free enterprise and given the private enterprise its rightful place alongside the public sector; *second*, greater domestic and foreign competition to domestic private and public sector companies which has multiplied choices for the consumers, compelled increases in efficiencies, *third*, the growing reliance placed by private and as well as public sector companies on capital markets, underpinning the need for better disclosures; *fourth*, the consequential changes in the shareholding pattern of private and public sector companies; *fifth*, the growing awareness of investors and investor groups, about their rights; *sixth*, the rise of institutional investors, with the public financial institutions gradually asserting themselves and transforming themselves into their new role as active shareholders than as lenders; *seventh*, the stock exchanges becoming gradually conscious of their roles as self regulatory organisations and exploring the possibility of using the listing agreement as a tool for raising standards of corporate governance; *eighth*, putting in place a comprehensive regulatory framework for the securities markets with the setting up of the Securities and Exchange Board of India (SEBI), as the statutory regulatory body for the securities market to protect the rights of investors and to regulate the securities markets.

3.4 There are several issues, which become relevant in the context of corporate governance in India. These begin with the definition of the very concept of corporate governance itself and its instrumentality, and navigate through the roles of various entities, which have different relationships with the firm – i.e. the insiders viz. - the promoters, the board of directors and the management, employees and the outsiders – the shareholders, the suppliers, the creditors, and the lenders; the perceptions about corporate governance by each of these groups; the role of the stock exchanges and the adequacy and effectiveness of the regulatory framework.

The Need for a framework of Corporate Governance

3.5 While some Indian companies, have voluntarily established high standards of corporate governance, but there are many more, whose practices are a matter of concern. There is also an increasing concern about standards of financial reporting and accountability, especially after losses suffered by investors and lenders in the recent past, which could have been avoided, with better and more transparent reporting practices. Investors have suffered on account of unscrupulous management of the companies, which have raised capital from the market at high valuations and have performed much worse than the past reported figures, leave alone the future projections at the time of raising money. Another example of bad governance has been the allotment of promoter's shares, on preferential basis at preferential prices, disproportionate to market valuation of shares, leading to further dilution of wealth of minority shareholders. This practice has however since been contained.

3.6 There are also many companies, which do not pay adequate attention to the basic procedures for shareholders' service; for example, many of these companies do not pay adequate attention to redress investors' grievances such as delay in transfer of shares, delay in dispatch of share certificates and dividend warrants and non-receipt of dividend warrants; companies also do not pay sufficient attention to timely dissemination of information to investors as also to the quality of such information.

3.7 There was a debate in India about whether the governance standards are better left voluntary or have some regulatory impact. It was generally felt that a statutory rather than a voluntary code would be far more purposive and meaningful, at least in respect of essential features of corporate governance, especially under Indian conditions.

3.8 Corporate governance is considered an important instrument of investor protection, and it is therefore a priority on SEBI's agenda. To further improve the level of corporate governance, need was felt for a comprehensive approach at this stage of development of the capital market, to accelerate the adoption of globally acceptable practices of corporate governance. This would ensure that the Indian investors are in no way less informed and protected as compared to their counterparts in the best-developed capital markets and economies of the world.

Appointment of the Birla committee

3.9 In the above mentioned context, the Securities and Exchange Board of India (SEBI) appointed the Committee on Corporate Governance on May 7, 1999 under the Chairmanship of Shri Kumar Mangalam Birla, member SEBI Board, to promote and raise the standards of Corporate Governance. The detailed terms of the reference are as follows:

a) *to suggest suitable amendments to the listing agreement executed by the stock exchanges with the companies and any other measures to improve the standards of corporate governance in the listed companies, in areas such as continuous disclosure of material information, both financial and non-financial, manner and frequency of such disclosures, responsibilities of independent and outside directors;*

b) *to draft a code of corporate best practices; and*

c) *to suggest safeguards to be instituted within the companies to deal with insider information and insider trading.*

The primary objective of the Committee was to view corporate governance from the perspective of the investors and shareholders and to prepare a Code to suit the Indian corporate environment, as corporate governance frameworks are not exportable.

Steps already taken by SEBI

3.10 Separately SEBI had taken various steps for strengthening corporate governance, some of which are:

- *strengthening of disclosure norms for Initial Public Offers*
- *providing information in directors' reports for utilisation of funds and variation between projected and actual use of funds according to the requirements of the Companies Act; inclusion of cash flow and funds flow statement in annual reports ;*
- *declaration of quarterly results;*
- *mandatory appointment of compliance officer for monitoring the share transfer process and ensuring compliance with various rules and regulations;*
- *timely disclosure of material and price sensitive information including details of all material events having a bearing on the performance of the company;*
- *despatch of one copy of complete balance sheet to every household and abridged balance sheet to all shareholders;*
- *issue of guidelines for preferential allotment at market related prices; and*
- *issue of regulations providing for a fair and transparent framework for takeovers and substantial acquisitions.*

The Approach

3.11 The Committee identified the three key constituents of corporate governance as the Shareholders, the Board of Directors and the Management and has attempted to identify in respect of each of these constituents, their roles and responsibilities as also their rights in the context of good corporate governance. Fundamental to this examination and permeating throughout this exercise is the recognition of the three key aspects of corporate governance, namely; accountability, transparency and equality of treatment for all stakeholders.

3.12 The pivotal role in any system of corporate governance is performed by the board of directors. It is accountable to the stakeholders and directs and controls the Management. It stewards the company, sets its strategic aim and financial goals and oversees their implementation, puts in place adequate internal controls and periodically reports the activities and progress of the company in the company in a transparent manner to the stakeholders. The shareholders' role in corporate governance is to appoint the directors and the auditors and to hold the board accountable for the proper governance of the company by requiring the board to provide them periodically with the requisite information ,in a transparent fashion, of the activities and progress of the company. The responsibility of the management is to undertake the management of the company in terms of the direction provided by the board, to put in place adequate control systems and to ensure their operation and to provide information to the board on a timely basis and in a transparent manner to enable the board to monitor the accountability of management to it.

3.13 Crucial to good corporate governance is the existence and enforceability of regulations relating to insider information and insider trading. Adequate financial reporting and disclosure are the corner stones of good corporate governance. These demand the existence and implementation of proper accounting standards and disclosure requirements. A separate committee appointed by SEBI looked into these issues and advised that while in most areas, accounting standards in India are comparable with International Accounting Standards both in terms of coverage and content, there are a few areas where additional standards need to be introduced in India.

3.14 The Committee's draft report was made public through the media and also put on the web site of SEBI for comments. The final report was approved by the Board of SEBI and has been enforced by SEBI through the listing agreements of the stock exchanges, which were amended under the directions of SEBI.

Applicability

3.15 The recommendations in the report were both mandatory and non mandatory. The mandatory recommendations are those which are absolutely essential for the framework of corporate governance and virtually form its core, and the others which are considered as desirable make up the non-mandatory recommendations. The listed companies, to whom this code will apply, in accordance with a prescribed time table will be required to comply with the mandatory recommendations and report in the annual reports about the status of compliance with the non-mandatory recommendations.

3.16 All companies which are seeking listing for the first time, will have to immediately comply with the requirements. About top 150 companies which account for more than 80 per cent of the market capitalisation on the Stock Exchange Mumbai and the national stock Exchange, and also have large shareholder base will be required to comply with the requirement within financial year 2000-2001,but not later than March 31, 2001. However to comply with the recommendations, these companies may have to begin the process of implementation as early as possible. Companies with paid up capital of a minimum of Rs 100 million or networth of Rs 250 million will have to comply with the requirement within financial year 2001-2002,but not later than March 31, 2002. In the next financial year 2002-2003,but not later than March 31, 2003 all companies which are presently listed, with paid up share capital of at least Rs 30 million will be required to comply.

3.17 This Report is the first formal and comprehensive attempt to evolve a Code of Corporate Governance, in the context of prevailing conditions of governance in Indian companies, as well as the state of capital markets. While making the recommendations the Committee has been mindful that any code of Corporate Governance must be dynamic, evolving and should change with changing context and times. It would therefore be necessary that this code also is reviewed from time to time, keeping pace with the changing expectations of the investors, shareholders, and other stakeholders and with increasing sophistication achieved in capital markets.

The Recommendations

Board of Directors

3.18 The board of a company provides leadership and strategic guidance, objective judgement independent of management to the company and exercises control over the company, while remaining at all times accountable to the shareholders. The board directs the company, by formulating and reviewing company's policies, strategies, 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, change in financial control and compliance with applicable laws, taking into account the interests of stakeholders. It controls the company and its management by laying down the code of conduct, overseeing the process of disclosure and communications, ensuring that appropriate systems for financial control and reporting and monitoring risk are in place, evaluating the performance of management, chief executive, executive directors and providing checks and balances to reduce potential conflict between the specific interests of management and the wider interests of the company and shareholders including misuse of corporate assets and abuse in related party transactions. It is accountable to the shareholders for creating, protecting and enhancing wealth and resources for the company, and reporting to them on the performance in a timely and transparent manner. However, it is not involved in day-to-day management of the company, which is the responsibility of the management.

Composition of the Board of Directors

3.19 The composition of the board is important in as much as it determines the ability of the board to collectively provide the leadership and ensures that no one individual or a group is able to dominate the board. The executive directors (like director-finance, director-personnel) are involved in the day to day management of the companies; the non-executive directors bring external and wider perspective and independence to the decision making. Till recently, it has been the practice of most of the companies in India to fill the board with representatives of the promoters of the company, and independent directors if chosen were also handpicked thereby ceasing to be independent. This has undergone a change and increasingly the boards comprise of following groups of directors - promoter director, executive and non executive directors, a part of whom are independent.

A conscious distinction has been made by the Committee between two classes of non-executive directors, namely, those who are independent and those who are not.

Independent directors and the definition of independence

3.20 Among the non-executive directors are independent directors, who have a key role in the entire mosaic of corporate governance. The Committee was of the view that it was important that independence be suitably, correctly and pragmatically defined, so that the definition itself does not become a constraint in the choice of independent directors on the boards of companies. The definition should bring out what in the view of the Committee is the touchstone of independence, and which should be sufficiently broad and flexible. It was agreed that "material pecuniary relationship which affects independence of a director" should be the litmus test of independence and the board of the company would exercise sufficient degree of maturity when left to itself, to determine whether a director is independent or not. *The concept of "independence" in independent directors was defined as Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgement of the board may affect their independence of judgement. Further, all pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report.*

3.21 The Indian law however does not make any distinction between the different categories of directors and all directors are equally and collectively responsible in law for the board's actions and decisions. The non-executive directors, i.e. those who are independent and those who are not, help bring an independent judgement to bear on board's deliberations especially on issues of strategy, performance, management of conflicts and standards of conduct. The calibre of the non-executive directors of appropriate calibre, especially of the independent directors was therefore important.

3.22 Good corporate governance dictates that the board be comprised of individuals with certain personal characteristics and core competencies such as recognition of the importance of the board's tasks, integrity, a sense of accountability, track record of achievements, and the ability to ask tough questions. Besides, having financial literacy, experience, leadership qualities and the ability to think strategically, the directors must show significant degree of commitment to the company and devote adequate time for meeting, preparation and attendance. The Committee is also of the view that it is important that adequate compensation package be given to the non-executive independent directors so that these positions become sufficiently financially attractive to attract talent and that the non executive directors are sufficiently compensated for undertaking this work.

3.23 Independence of the board is critical to ensuring that the board fulfils its oversight role objectively and holds the management accountable to the shareholders. The following structure and composition of the board and of the committees of the board have recommended.

3.24 *The Board of a company must have an optimum combination of executive and non-executive directors with not less than fifty percent of the board comprising the non-executive directors. The number of independent directors (independence being as defined in the foregoing paragraph) would depend on the nature of the chairman of the board. In case a company has a non-executive chairman, at least one-third of board should comprise of independent directors and in case a company has an executive chairman, at least half of board should be independent.*

This is a mandatory recommendation.

3.25 The tenure of office of the directors will be as prescribed in the Companies Act.

Nominee Directors

3.26 Besides the above categories of directors, there is another set of directors in Indian companies who are the nominees of the financial or investment institutions to safeguard their interest. The nominees of the institutions are often chosen from among the present or retired employees of the institutions or from outside. In the context of corporate governance, there could be arguments both for and against the continuation of this practice.

3.27 There are arguments both for and against the institution of nominee directors. Those who favour this practice argue that nominee directors are needed to protect the interest of the institutions who are custodians of public funds and who have high exposures in the projects of the companies both in the form of equity and loans. On the other hand those who oppose this practice, while conceding that financial institutions have played a significant role in the industrial development of the country as a sole purveyor of long term credit, argue that there is an inherent conflict when institutions through their nominees participate in board decisions and in their role as shareholders demand accountability from the board. They also argue that there is a further conflict because the institutions are often major players in the stock market in respect of the shares of the companies on which they have nominees.

3.28 *Both points of view have their merits. Clearly when companies are well managed and performing well, the need for protection of institutional interest is much less than when companies are badly managed or under-performing. It was therefore recommended that institutions should appoint nominees on the boards of companies only on a selective basis where such appointment is pursuant to a right under loan agreements or where such appointment is considered necessary to protect the interest of the institution*.

3.29 Besides when a nominee of the institutions is appointed as a director of the company, he should have the same responsibility, be subject to the same discipline and be accountable to the shareholders in the same manner as any other director of the company. In particular, if he reports to any department of the institutions on the affairs of the company, the institution should ensure that there exist Chinese walls between such department and other departments which may be dealing in the shares of the company in the stock market.

Chairman of the Board

3.30 The role of Chairman is to ensure that the board meetings are conducted in a manner which secures the effective participation of all directors, executive and non-executive alike, and encourages all to make an effective contribution, maintain a balance of power in the board, make certain that all directors receive adequate information, well in time and that the executive directors look beyond their executive duties and accept full share of the responsibilities of governance. The Chairman's role should in principle be different from that of the chief executive, though the same individual may perform both roles.

3.31 Given the importance of Chairman's role, the Committee recommended that a non-executive Chairman should be entitled to maintain a Chairman's office at the *company's expense and also allowed reimbursement of expenses incurred in performance of his duties. This will enable him to discharge the responsibilities effectively.*

This is a non-mandatory recommendation.

Audit Committee

3.32 There are few words more reassuring to the investors and shareholders than accountability. A system of good corporate governance promotes relationships of accountability between the principal actors of sound financial reporting – the board, the management and the auditor. It holds the management accountable to the board and the board accountable to the shareholders. The audit committee's role flows directly from the board's oversight function. It acts as a catalyst for effective financial reporting.

3.33 A proper and well functioning system exists therefore, when the three main groups responsible for financial reporting – the board, the internal auditor and the outside auditors – form the three-legged stool that supports responsible financial disclosure and active and participatory oversight. The audit committee has an important role to play in this process, since the audit committee is a sub-group of the full board and hence the monitor of the process. Certainly, it is not the role of the audit committee to prepare financial statements or engage in the myriad of decisions relating to the preparation of those statements. The committee's job is clearly one of oversight and monitoring and in carrying out this job it relies on senior financial management and the outside auditors. However it is important to ensure that the boards function efficiently for if the boards are dysfunctional, the audit committees will do no better. The progressive standards of governance applicable to the full board should also be applicable to the audit committee.

3.34 *The Committee therefore recommended that a qualified and independent audit committee should be set up by the board of a company. This would go a long way in enhancing the credibility of the financial disclosures of a company and promoting transparency*.

This is a mandatory recommendation.

Composition

3.35 The composition of the audit committee is based on the fundamental premise of independence and expertise. *The Committee therefore recommended that the audit committee should have minimum three members, all being non executive directors, with the majority being independent, and with at least one director having financial and accounting knowledge;*

- *the chairman of the committee should be an independent director;*
- *the chairman should be present at Annual General Meeting to answer shareholder queries;*
- *the audit committee should invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the Committee but on occasions it may also meet without the presence of any executives of the company. Finance director and head of internal audit and when required, a representative of the external auditor should be present as invitees for the meetings of the audit committee;*
- *the Company Secretary should act as the secretary to the committee.*
  <u>These are mandatory recommendations</u>.

Frequency of meetings and quorum

3.36 The audit committee should meet at least thrice a year. One meeting must be held before finalisation of annual accounts and one necessarily every six months.
<u>This is a mandatory recommendation</u>

3.37 The quorum should be either two members or one-third of the members of the audit committee, whichever is higher and there should be a minimum of two independent directors.
<u>This is a mandatory recommendation.</u>

Powers of the audit committee

Being a committee of the board, the audit committee derives its powers from the authorisation of the board. Such powers should include powers:

- *To investigate any activity within its terms of reference.*
- *To seek information from any employee.*
- *To obtain outside legal or other professional advice.*

- *To secure attendance of outsiders with relevant expertise, if it considers necessary.*

<u>This is a mandatory recommendation.</u>

Functions of the Audit Committee

3.38 *As the audit committee acts as the bridge between the board, the statutory auditors and internal auditors, its role should include the following*

- *Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.*
- *Recommending the appointment and removal of external auditor, fixation of audit fee and also approval for payment for any other services.*
- *Reviewing with management the annual financial statements before submission to the board, focussing primarily on:*
- *Any changes in accounting policies and practices.*
- *Major accounting entries based on exercise of judgement by management.*
- *Qualifications in draft audit report.*
- *Significant adjustments arising out of audit.*
- *The going concern assumption.*
- *Compliance with accounting standards*
- *Compliance with stock exchange and legal requirements concerning financial statements.*
- *Any related party transactions i.e. transactions of the company of material nature, with promoters or the management, their subsidiaries or relatives etc. that may have potential conflict with the interests of company at large.*
- *Reviewing with the management, external and internal auditors, the adequacy of internal control systems.*
- *Reviewing the adequacy of internal audit function, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure, coverage and frequency of internal audit.*
- *Discussing with internal auditors of any significant findings and follow-up thereon.*
- *Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.*

- *Discussing with external auditors before the audit commences, of the nature and scope of audit. Also post-audit discussion to ascertain any area of concern.*
- *Reviewing the company's financial and risk management policies.*
- *Looking into the reasons for substantial defaults in the payments to the depositors, debenture holders, share holders (in case of non-payment of declared dividends) and creditors.*

This is a mandatory recommendation

Remuneration Committee of the Board

3.39 A company must have a credible and transparent policy in determining and accounting for the remuneration of the directors. The policy should avoid potential conflicts of interest between the shareholders, the directors, and the management. The overriding principle in respect of directors' remuneration is that of openness and shareholders are entitled to a full and clear statement of benefits available to the directors.

3.40 *For this purpose the Committee while recommending that the board should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, it made the recommendation non-mandatory.*

Composition, Quorum etc. of the Remuneration Committee

3.41 To avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors should comprise of at least three directors, all of whom should be non-executive directors, the chairman of committee being an independent director.

3.42 The Chairman of the remuneration committee should be present at the Annual General Meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.

All the above recommendations are non-mandatory.

3.43 *The Committee recommends that the board of directors should decide the remuneration of non-executive directors.*
<u>This is a mandatory recommendation.</u>

Disclosures of Remuneration Package

3.44 It is important for the shareholders to be informed of the remuneration of the directors of the company and all annual reports must contain disclosures about a*ll elements of remuneration package of all the directors i.e. salary, benefits, bonuses, stock options, pension etc.; details of fixed component and performance linked incentives, along with the performance criteria; service contracts, notice period, severance fees; stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.*
<u>This is a mandatory recommendation.</u>

Board Procedures

3.45 The measure of the board is buttressed by the structures and procedures of the board. The various committees of the board recommended in this report would enable the board to have an appropriate structure to assist it in the discharge of its responsibilities. These need to be supplemented by certain basic procedural requirements in terms of frequency of meetings, the availability of timely information, sufficient period of notice for the board meeting as well as circulation of agenda items well in advance, and more importantly, the commitment of the members of the board. The *board meetings should be held at least four times in a year, with a maximum time gap of four months between any two meetings and certain minimum information should be available to the board.*
<u>This is a mandatory recommendation.</u>

3.46 *Besides to ensure that the members of the board give due importance and commitment to the meetings of the board and its committees, there should be a ceiling on the maximum number of committees across all companies in which a director could be a member or act as Chairman. A director should not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company*

about the committee positions he occupies in other companies and notify changes as and when they take place.
<u>This is a mandatory recommendation.</u>

Accounting Standards and Financial Reporting

3.47 Over time the financial reporting and accounting standards in India have been upgraded. This however is an ongoing process and we have to move speedily towards the adoption of international standards. This is particularly important from the angle of corporate governance. *The following changes have been recommended:*

<u>Consolidation of Accounts of subsidiaries</u>

3.48 *The companies should be required to give consolidated accounts in respect of all its subsidiaries in which they hold 51 % or more of the share capital.*

<u>Segment reporting where a company has multiple lines of business.</u>

3.49 Equally in cases of companies with several businesses, it is important that financial reporting in respect of each product segment should be available to shareholders and the market to obtain a complete financial picture of the company.

<u>Disclosure and treatment of related party transactions.</u>

3.50 This again is an important disclosure as pointed out before and *the Institute of Chartered Accountants of India has been requested to finalise this at the earliest. In the interim, the Committee recommends the disclosures set out in Clause 7 of Annexure-4*

<u>Treatment of deferred taxation</u>

3.51 The treatment of deferred taxation and its appropriate disclosure has an important bearing on the true and fair view of the financial status of the company. *And hence should be a part of the annual accounts.*

Management

3.52 In the view of the Committee, the over-riding aim of management is to maximize shareholder value without being detrimental to the interests of other stakeholders. The management however, is subservient to the board of directors and must operate within the boundaries and the policy framework laid down by the board. While the board is responsible for ensuring that the principles of corporate governance are adhered to and enforced, the real onus of implementation lies with the management. It is responsible for translating into action, the policies and strategies of the board and implementing its directives to achieve corporate objectives of the company framed by the board. It is therefore essential that the board should clearly define the role of the management.

<u>Functions of the Management</u>

3.53 The management comprises the Chief Executive, Executive-directors and the key managers of the company, involved in day-to-day activities of the company.

3.54 The management should carry out the following functions:

- Assisting the board in its decision making process in respect of the company's strategy, policies, code of conduct and performance targets, by providing necessary inputs.
- Implementing the policies and code of conduct of the board.
- Managing the day to day affairs of the company to best achieve the targets and goals set by the board, to maximize the shareholder value.
- Providing timely, accurate, substantive and material information, including financial matters and exceptions, to the board, board-committees and the shareholders.
- Ensuring compliance of all regulations and laws.
- Ensuring timely and efficient service to the shareholders and to protect shareholder's rights and interests.
- Setting up and implementing an effective internal control systems, commensurate with the business requirements.
- Implementing and comply with the Code of Conduct as laid down by the board.
- Co-operating and facilitating efficient working of board committees.

3.55 As a part of the disclosure related to Management, the annual report must contain a Management Discussion and Analysis report should form part of the annual report to the shareholders and as a part of the directors' report or as an addition there to, This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:

- *Industry structure and developments.*
- *Opportunities and Threats*
- *Segment-wise or product-wise performance.*
- *Outlook.*
- *Risks and concerns*
- *Internal control systems and their adequacy.*
- *Discussion on financial performance with respect to operational performance.*
- *Material developments in Human Resources /Industrial Relations front, including number of people employed.*

This is a mandatory recommendation

3.56 Good corporate governance casts an obligation on the management in respect of disclosures. *The disclosures must be made by the management to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)*
This is a mandatory recommendation.

Shareholders

3.57 The shareholders are the owners of the company and as such they have certain rights and responsibilities. But in reality companies cannot be managed by shareholder referendum. The shareholders are not expected to assume responsibility for the management of corporate affairs. A company's management must be able to take business decisions rapidly. The shareholders have therefore to necessarily delegate many of their responsibilities as owners of the company to the directors who then become responsible for corporate strategy and operations. The implementation of this strategy is done by a management team. This relationship therefore brings in the accountability of the boards and the management to the shareholders of the company. A good corporate framework is one that provides adequate avenues to the shareholders for effective contribution in the governance of the company while insisting on a high standard of corporate behaviour without getting involved in the day to day functioning of the company.

Responsibilities of shareholders

3.58 The General Body Meetings provide an opportunity to the shareholders to address their concerns to the board of directors and comment on and demand any explanation on the annual report or on the overall functioning of the company. It is important that the shareholders use the forum of general body meetings for ensuring that the company is being properly stewarded for maximising the interests of the shareholders. This is important especially in the Indian context. It follows from the above, that for effective participation shareholders must maintain decorum during the General Body Meetings.

3.59 The effectiveness of the board is determined by the quality of the directors and the quality of the financial information is dependent to an extent on the efficiency with which the auditors carry on their duties. The shareholders must therefore show a greater degree of interest and involvement in the appointment of the directors and the auditors. Indeed, they should demand complete information about the directors before approving their directorship.

3.60 It is therefore recommended that in case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:

A brief resume of the director;

Nature of his expertise in specific functional areas; and

Names of companies in which the person also holds the directorship and the membership of Committees of the board.

<u>This is a mandatory recommendation</u>

Shareholders' rights

3.61 The basic rights of the shareholders include right to transfer and registration of shares, obtaining relevant information on the company on a timely and regular basis, participating and voting in shareholder meetings, electing members of the board and sharing in the residual profits of the corporation.

3.62 *As shareholders have a right to participate in, and be sufficiently informed on decisions concerning fundamental corporate changes, they should not only be provided information as under the Companies Act, but also in respect of other decisions relating to material changes such as takeovers, sale of assets or* *divisions of the company and changes in capital structure which will lead to change in control or may result in certain shareholders obtaining control disproportionate to the equity ownership.*

The information like quarterly results, presentation made by companies to analysts may be put on company's web-site or may be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.

<u>This is a mandatory recommendation.</u>

3.63 A company must have appropriate systems in place which will enable the shareholders to participate effectively and vote in the shareholders' meetings. The company should also keep the shareholders informed of the rules and voting procedures, which govern the general shareholder meetings.

3.64 The annual general meetings of the company should not be deliberately held at venues or the timing should not be such which makes it difficult for most of the shareholders to attend. The company must also ensure that it is not inconvenient or expensive for shareholders to cast their vote. Often the formality of holding the general meeting is gone through and only a small fraction of the shareholders of that company do or can really participate therein. This virtually makes the concept of corporate democracy illusory. It is imperative that this situation which has lasted too long needs an early correction. In this context, for shareholders who are unable to attend the meetings, there should be a requirement which will enable them to vote by postal ballot for key decisions.

3.65 A *board committee under the chairmanship of a non-executive director should be formed to specifically look into the redressing of shareholder complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. The formation of such a committee will help focus the attention of the company on shareholders' grievances and sensitise the management to redress their grievances.*

<u>This is a mandatory recommendation</u>

3.66 In the cases of companies whose securities are still in the physical form, the process of share transfer of securities must be expedited and the power of share transfer currently exercised by the board of the company should be delegated to *an officer, or a committee or to the registrar and share transfer agents. The delegated authority should attend to share transfer formalities at least once in a fortnight.*

<u>This is a mandatory recommendation.</u>

Institutional shareholders

3.67 Institutional shareholders have acquired large stakes in the equity share capital of listed Indian companies. They have or are in the process of becoming majority shareholders in many listed companies and own shares largely on behalf of the retail investors. They thus have a special responsibility given the weightage of their votes and have a bigger role to play in corporate governance as retail investors look upon them for positive use of their voting rights.

3.68 Given the weight of their votes, the institutional shareholders can effectively use their powers to influence the standards of corporate governance. Practices elsewhere in the world have indicated that institutional shareholders can sufficiently influence because of their collective stake, the policies of the company so as to ensure that the company they have invested in, complies with the corporate governance code in order to maximise shareholder value. What is important is that, the institutional shareholders put to good use their voting power

3.69 The institutional shareholders must

- take active interest in the composition of the Board of Directors
- be vigilant
- maintain regular and systematic contact at senior level for exchange of views on management, strategy, performance and the quality of management.
- ensure that voting intentions are translated into practice
- evaluate the corporate governance performance of the company

3.70 The disclosures in the Annual Reports of companies to which this code will apply must henceforth include a separate section on Corporate Governance with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory recommendation with reasons thereof and the extent to which the non-mandatory recommendations have been adopted should be specifically highlighted. This will enable the shareholders and the securities market to assess for themselves the standards of corporate governance followed by a company.

<u>This is a mandatory recommendation.</u>

3.71 *The company should arrange to obtain a certificate from the auditors of the company regarding compliance of mandatory recommendations and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate should also be sent to the stock exchanges along with the annual returns filed by the company.*
<u>This is a mandatory recommendation</u>

End Note

3.72 There are several corporate governance structures available in the developed world but there is no one structure, which can be singled out as being better than the others. There is no "one size fits all" structure for corporate governance. The recommendations are not therefore based on any one model but are designed for the Indian environment. Corporate governance extends beyond corporate law. Its fundamental objective is not mere fulfillment of the requirements of law but in ensuring commitment of the board in managing the company in a transparent manner for maximising long term shareholder value. The corporate governance has as many votaries as claimants. Among the latter, the recommendations are focussed on investors and shareholders, as they are the prime constituencies of SEBI. As would be seen the issues raised in the first section on expropriation by the managers, availability of mechanisms for exercise of voting rights by the shareholders, the need for appropriate board structure, disclosures about related party transactions and perquisites, fidelity of accounts have all been addressed. The recommendations also compare favourably with the codes, guidelines and other corporate governance instruments available in other markets. But the effectiveness of corporate governance system cannot merely be legislated by law neither can any system of corporate governance be static. As competition increases, technology pronounces the death of distance and speeds up communication, the environment in which firms operate in India also changes. In this dynamic environment the systems of corporate governance also need to evolve. The recommendations will go a long way in raising the standards of corporate governance in Indian firms and make them attractive destinations for local and global capital. These recommendations will also form the base for further evolution of the structure of corporate governance in consonance with the rapidly changing economic and industrial environment of the country in the new millenium.

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