Volume 1, No. 1 2009

Journal on Governance

Articles

Notes & Comments

Journal on Governance

Volume 1, No. 1 2009

MESSAGE TO NATIONAL LAW UNIVERSITY, JODHPUR

The National Law University is indeed one of the finest temples of learning, which can be benchmarked with the global best in this domain.

It has built its splendid reputation not only on the strength of its holistic approach to the study of law, justice and management and the immense intellectual fervour that the faculty stimulate among the students, but much more. I for one, have been most impressed by the values you endeavour to inculcate in your students. Importantly, sound ethics and the highest form of governance, seem to course through your University. That, I feel, is the DNA of this school - which has spawned many law luminaries in India.

Even as I compliment your entire faculty for taking this Institute to such a high, I am sure, the leadership of thinkers and intellectual giants, I allude to your Chancellor - Honourable Justice Mr. Jagdish Bhalla, Chief Justice of Rajasthan High Court and Vice Chancellor - Justice Mr. N. N. Mathur, - will take the National Law University to stratospheric heights.

I feel very proud to have been associated with this prestigious Institute.

D. D. Rathi
Director, Grasim Industries

EDITORIAL

The Conference on Governance was organised in the National Law University, Jodhpur on 18th -19th March, 2009 with a view to initiate a discussion and debate on the major issues regarding political, administrative and corporate governance in civil society. A number of dignitaries honoured the conference with their presence and the authors of the papers presented mechanisms and solutions to address contemporary problem the failure of governance. The Journal on Governance is another step towards the idea of increasing awareness and responsibility, incorporating the plausible yet simple suggestions through articles, notes and essays.

The Journal on Governance is an evidence of the invincible research, thought provoking ideas and significant academic and intellectual standards. Care has been taken that the selected works of the contributors present solutions to the present malaise of lack of values in both public and private sector, to appraise the role of civil society as a monitoring agency and to evolve consensus on how to conduct administration and business responsibly. In the process of the publication of this journal and also through the conference we have been able to receive valuable insight and guidance from the esteemed members of the advisory board which has invariably contributed to the real-life significance of this venture.

The Journal on Governance shall be made a bi-annual feature with a view to keep progressing the objective of creating a responsible and well-governed society. The subsequent issues shall pertain on more specific areas of governance and a social responsibility and we hope that this effort on our behalf is received well among the readers. Contributions and suggestions for helping the Journal on Governance nurture in its endeavour shall be appreciated.

CONTENT

Corporate Governance Ratings & Their Implications to the Stakeholders of a Company

Divya Meghwanshi & Rishabh Chopra

Enron and WorldCom [USA], Ahold, Parmalat and Skandia [Europe], UTI and Satyam [IndiaJ-these companies have many things in common. They were once glorious companies with a proud record; they were the darling of the stock markets. They have however another feature in common- they were also ravaged by scandals and scams and are now only a shadow of their former selves, if at all they survived in the first place. And the greatest sufferers in all this have been the small shareholders, the common man on the street who invested money in them with the only intention being perhaps to secure their future or to get some extra money.

The primary reason for such corporate collapses is improper corporate governance or lack of corporate governance or perhaps a mixture of both. So shareholders and the other investors now demand to know if the company follows the principles of corporate governance and to what extent they follow it.

Although, to satisfy this ever-increasing demand, a new tool was devised called the CORPORATE GOVERNANCE RATINGS nevertheless, it is very important to study how these ratings affect the stakeholders in the company and whether they influence the stakeholders to make a decision as to whether they should or should not be associated with the company. It is with this intention that this article has been taken up by the authors. The article before analyzing the implication of Corporate Governance Rating on the different stakeholders provides the basis for the further understanding of their importance to the different stakeholders like shareholders, creditors companies etc. of a company. Also along with the implications on the respective stakeholders, it describes the disadvantages which are attached with the present Corporate Governance Ratings.

' Students, 5* Year, National Law University, Jodhpur

CONTENTS

I. Corporate Governance Ratings

A. An Overview

Awareness of corporate governance and its role in the global economy has grown steadily in recent years. Stock exchanges and regulators around the world increasingly look to set standards or codes of best practice for corporate governance. Moreover, investors are beginning to review more systematically a company's corporate governance practices as part of the investment decision making process; the reason of course is the revelation of various fraudulent practices by the companies against the interest of these investors, shareholders, employees, customers, the environment and the local community.[1]

In the context of this growing interest in corporate governance, there is a role for global benchmarks to help a company's shareholders, managers, directors or other stakeholders to objectively assess and compare corporate governance practices from one firm to another and from one country to another. The concept of corporate governance rating, or scoring, is a way to address this gap, and several firms around the world have either launched governance scoring activities or are actively exploring entry into this area. Some of these international firms are Deminor, ISS, Moody's, Standard and Poor's, etc. Indian firms are also not far behind in this context and many firms have launched Corporate Governance Ratings. These firms are:

1. Credit Rating Information Services of India Limited (CRISIL)

'http://www2.standardandpoors.corr^servlet/Satellite?r=l&l=EN&b=ll&f=ls=18&ig=&i=& pagename=sp/sp_product/ProductBodyTemplate&cid= 1021984025974 <visited on February 14,2009>

2. Investment Information and Credit Rating Agency of India (ICRA)
3. Credit Analysis & Research Limited (CARE)
4. Duff & Phelps Credit Rating India Private Ltd. (DCR India)[2]

According to ICRA a Corporate Governance Rating reflects rating the agency's assessment of a company's corporate governance practices and policies and the extent to which these serve the interests of the company's financial stakeholders, particularly shareholders. While a Corporate Governance Rating can affect the attractiveness of a company to potential investors, Corporate Governance Rating is not intended iO be an opinion on specific financial obligation, credit quality, capital market valuation or operational performance. It is not an audit, a rating or a financial advice nor is it a recommendation to take any financial decision. Also Corporate Governance Rating is not to be interpreted as an indicator of statutory compliance.[3]

B. Rating Criteria

There are different criteria used to give these ratings. As owners, the shareholders bear a duty to control the company by electing the board of directors to represent them. Board members should act in good-faith, with loyalty and care and in the best interest of the company and the shareholders, which includes determining corporate strategies and policies to sustain the company's continuous and steady growth. It'is then the management's duty to

[2] www.indiaonestop.com/creditrating.htm<visited on March 4, 2009>
[3] www.ficci.com/media-room/speeches-presentations/2003/aug/aug6-capam-chaudhari.ppt <visited on February 25, 2009>

carry out the company's daily tasks to achieve the objectives and targets set by the board of directors. From this basis, different criteria can be evolved for measuring the corporate governance practices in a company.

Standard and Poor's use the following criteria to undertake its Corporate Governance Ratings[4]:

1. Shareholder Rights and Stakeholder Relations[5]
    - Shareholder Meeting and Voting Procedures
    - Ownership Rights and Takeover Defenses
    - Stakeholder Relations
2. Ownership structure and external influences
    - Transparency of Ownership
    - Concentration and Influence of Ownership and External Stakeholders
3. Transparency, Disclosure and Audit
    - Content of Public Disclosure

[4] http://www2.standardandpoors.com/servlet/Satellite?r= 1 &l=EN&b= 11 &f= 1 s= 18&ig=&i=& pagename=sp/sp_product/ProductBodyTemplate&cid=1021984025974<visited on March 6, 2009>

[5] Each of these criterions can be further divided into many sub-headings which help the rating agencies to collect the required information in a detained manner. For instance, for the first criterion, further sub-headings could be, as discussed above-

1. The mechanisms that ensure all shareholders are able to gain their full benefits.
2. The mechanisms that ensure all shareholders are able to exercise their voting rights.
3. Whether all shareholders have equal basic rights.

- Timing of, and Access to, Public Disclosure
- The Audit Process

4. Board Structure and Effectiveness

- Board Structure and Independence
- Role and effectiveness of the Board
- Senior Executive and Director Compensation

Thus, the criteria for evaluating the corporate governance standards differ from agency to agency. For instance, ISS measures 63 variables for coming out with a Corporate Governance Rating which it calls as the CGQ.[6] Even here, there are different rating scales or weights that are attached to each criterion which differ from agency to agency. For instance, ICRA uses a 6-point rating scale viz. CGR 1 to CGR 6, with CGR 1 being the highest rating available. CARE has a 6-point rating scale CARE CGR 1 upto CARE CGR 6, the former being the highest and the latter the lowest. But what constitutes CGR 1 in ICRA may not be present in CARE CGR 1 and instead some other parameters may be present there.

C. Rating Process

The rating agency generally undertakes Corporate Governance Rating exercise only with the full co-operation of the entity being rated. However, it may also do such an exercise on behalf of other stakeholders as well. It undertakes perusal of various documents like agenda papers and minutes of

[6] http://www.issproxy.com/cgq/evolve.jsp<visited on January 14, 2009>

Board and Board committees, Annual return and other documents filed by the company with ROC, SEBI, stock exchanges (domestic and international) and all other regulatory bodies, prospectus (if applicable), offer documents, minutes of the Annual General Meeting and Extraordinary general meeting. Thereafter the agency interacts with the Chairman, CEO and Independent Directors, key officials of the company, Statutory Auditors, Internal Auditors, Lenders and Institutional/major shareholders and based on their answers to the questions being put up for each area, scores are awarded according to a pre-determined scoring system. The score for that area is then multiplied by a factor or weight. The adjusted scores are totaled, converted to a percentage, and then expressed as a rating. The rating report gives performance indications for and commentary on, each of the key components of the governance rating. This is the basic process conducted and the rating companies can use some other process also, taking into account some more factors.[7]

II. OECD and Corporate Governance ratings

Corporate governance is something that is inherently subjective. What may be good corporate governance to one may not be so to another. In such a scenario producing a Corporate Governance Rating would have been a futile exercise had there been no universally acceptable understanding of good Corporate Governance. This gap has been fulfilled by the OECD by bringing the OECD principles of corporate governance which have found universal acceptance and have ensured that there is some uniformity in these ratings.

[7] http://www.coreratings.com<visited on February 14, 2009>

These are as follows-

1. Fairness
2. Accountability
3. Transparency
4. Responsibility

These principles determine if a corporation has good corporate governance practices or not. These principles also introduce a bit of commonness and uniformity in what is inherently a subjective field i.e. evaluation of corporate governance standards in an organization. Accordingly, the rating agencies have also based their ratings on above four principles itself. There are many broad criteria which are common to all rating agencies having the element of above principles which are looked into by these agencies, like[o]:

1. Voting at general meetings
2. Board Independence
3. Separating the role of chairman and CEO
4. Presence of audit, remuneration and nomination committees
5. Auditor's Independence etc.

Ibid

III. Corporate Governance Ratings & Credit Ratings: Distinction

Despite the prevailing trend of treating Corporate Governance Rating as an adjunct of credit rating particularly in emerging markets like India, there are some significant differences between the two. A credit rating is a current opinion on the relative ability of an issuer to meet its debt obligations as per terms, its determinants being business outlook, competitive position, operational efficiencies and financial position.[9] Whereas, a CGR is a current assessment of various company practices and procedures relative to the codes and standards of corporate governance.[10] The parameters, methodologies, target audiences and objectives of the two rating exercises are not identical, although they share certain common features. It is possible that a corporate entity following excellent corporate governance practices is unable to generate the kind of cash flows that would merit a high level of credit rating. Thus, credit rating and Corporate Governance Rating are not necessarily co-directional.

IV. Implications to the Stakeholders

Company is an artificial entity and it requires many natural persons' contribution, performing different functions to carry out its activities. These are the stakeholders of the company like Shareholders, other investors, management, employees, suppliers etc.

[9] www.sec.gov/news/studies/credratingreport0103.pdf <visited on March 11,2009>
[10] http://www.icra.in/Ratings.aspx?id=7 <visited on March 10, 2009>

Corporate governance has now become one of the fundamental criteria for making any investment decisions in a company. A recent, well-publicized survey by McKinsey & Co. [McKinsey Investor Opinion Survey- June 2000],' in this regard is illuminating. In the survey, around one-fifth of the institutional investors in the sample expressed preference towards corporate governance over financials while deciding their emerging market portfolios. The survey, which covered a sample of 188 companies in six emerging markets, tested the link between market valuation and corporate governance. It established that companies with better corporate governance command a higher price-to-book ratio.[12] The study found that most investors believed that board practices are as important as financial performance.

The benefit, to all stakeholders, that a Corporate Governance Rating provides is that the focus is predominantly on substance over form. It is more the spirit than the letter of the relevant rules, procedures and codes which is important in such a rating. The sets of variables that have been identified are drawn from different guidelines, codes of governance and best practices and committee recommendations on the subject. These variables reflect the distribution of rights and responsibilities among the constituents of the corporate management including the shareholders, the board of directors, the executive management, and, of course, the committees constituted for specific purposes. In fact the significant difference between a Corporate Governance Rating and Corporate Governance Report is that companies in India are required to publish with the annual accounts under the terms of the Listing

[1] http://www.mckinsey.com/clientservice/organizationleadership/service/corpgovernance/ Ddf7Investor_Perspectives_Corp_Governance.pdf <visited on March 5, 2009>

[2] *Ibid*

Agreement [clause 49]. A Corporate Governance Report is complete even if it shows a mechanical compliance with the legal provisions. But this is not the case with a Corporate Governance Rating which looks more deeply into the corporate governance practices followed in the company and determine if there has been only mechanical compliance or if there has been a true internalization of the norms of code of corporate governance practices by the company. For this purpose, the ratings maintain a certain amount of flexibility given the nature of some of the issues involved. Examples of such issues include: actual number of "Independent" directors *vis-a-vis* the actual level of independence of such directors. [13] Thus, importance of Corporate Governance Ratings to different stakeholders is as follows:

A. Regulators

Corporate Governance Rating though not having any legal sanction until now, does provide great assistance to the regulators and other statutory authorities. It can be used as a check to determine the relative standing of the company with respect to the benchmarks of best corporate practices in the industry. In fact, it was the Securities and Exchange Board of India (SEBI) that sought the services of two of the leading credit rating agencies in the country - CRISIL and ICRA to prepare a comprehensive instrument for rating the good corporate governance practices of listed companies. This instrument will enable the securities market regulator to judge the compliance status of

[13] For instance, GMI, a Corporate Governance Rating agency lays down over 9 separate criter\ons WhVh would maVe a Sector*mb.eper« to%*1«p«H^taTtfttfr.Twife criterions are over and above what the legal requirements of an independent director.

corporations on parameters such as effective creation, management and distribution of investors' wealth.

B. Investors and other Stakeholders

CGR help investors to identify and compare corporate governance standards among different companies in an international context.[14] It helps them to understand the way companies operate and to benchmark and calibrate corporate governance risk characteristics, thus determining the appropriate risk-premium to understand how management treats the interests of shareholders, including minority shareholders, to understand the relative degree of transparency at a company and also to obtain additional information when making investment decisions.

Importantly, the rating process will take into account movements in the price of a company's stock prior to crucial announcements. Promises made to stakeholders and lenders with regard to policies and projects will be factored in. Strategies announced earlier on the end-use of funds will also be considered. [15]

C. Company

A good Corporate Governance Rating increases investor confidence and lowers the risk perception in the company. Corporate Governance Ratings

[14] http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/Page/AccessCodePg&cid=1099337169676<visited on January 14, 2009> [15] *Supra Note* 12

would enable corporate entities to obtain an independent and credible assessment of the quality and extent of their corporate governance. Thus the company can use it as a benchmark for internal improvement and can use it in investor relations programs to attract new and retain existing investors. A transparent regulatory framework and better disclosure systems are crucial for attracting domestic as well as foreign investment.[16] Better disclosure norms and better governance helps in the valuation of companies. An independent Corporate Governance Rating can tell companies where they stand and point out shortcomings in the system.

V. Instrument to Prevent Frauds

The perception of good corporate governance is an important ingredient of the image of an organization as it enhances the reputation of the organization and makes it more attractive to customers, investors and suppliers.[17] Good corporate governance thus certifies the compliance of all the governance norms by the organization which in other words means, it helps to prevent corporate scandals, fraud, and potential civil and criminal liability of the organization.

However, the question is how to ensure that the men who manage corporates comply with these norms. CGR can be used as an effective instrument in this regard to prevent frauds by ensuring that the CG norms are not only followed in letter but in spirit.

[16] http://www.ifc.org/ifcext/corporategovernance.ns£'AttachmentsByTitle/The_Irrisistible_Cas e Text/$FILE/IrresistibleCase4CG.pdf<visited on February 17, 2009>
[17] http://accounting.smartpros.com/x55104.xml <visited on March 11, 2009>

As discussed above function of rating agencies is nothing but to assess and rate different companies on the basis of their compliance with the CG norms. Corporate Governance Rating looks more deeply into the corporate governance practices followed in the company and determines if there has been only mechanical compliance or if there has been a true internalization of the norms of code of corporate governance practices by the company. According to Chairman, SEBI; corporate governance ratings, if based on "suitable model"[18], would help prevent companies or their managements from committing frauds.[19] Consequently, if the all the rating agencies follow an effective Rating mechanism it would deter unscrupulous corporate from duping investors as the corporate governance rating parameters developed by various agencies vet past governance standards and look into the track record of a company.[20]

Further a Corporate Governance Rating once accepted will be subject to regular periodic reviews. During these reviews the agency would incorporate the changes in corporate position on various parameters in the assigned Corporate Governance Ratings thus to ensure that ratings always reflect the current positions of the corporate governance practices being followed in the organization. These rating systems are designed to spotlight for investors the steps taken or not taken by companies to improve and

[18] "Suitable model" means an appropriate instrument based upon the principles laid down by OECD and international standards that can assess the standards of corporate governance not only on the basis of compliance with rules and regulations but also with the principles behind them. The rating should ensure that the implementation of the codes of corporate governance should be true in both letter and spirit.

[19] http://www.blonnet.com/bline/2002/07/12/stories/2002071202560300.htm <visited on March 9,2009>

[20] http://www.sebi.gov.in/chairmanspeech/memspl.pdf <visited on March 11, 2009>

manage corporate governance issues. In a sense, the rating systems merely represent an extension of well-established functions, such as corporate credit ratings. These ratings, however, have the potential to dramatically increase pressure on public companies to adopt specific policies in order to satisfy the criteria established by the entities that publish the rankings. The reason for the same being, these days the decisions of investors are highly influenced by the scores of these rating agencies. Such an attitude of the investors and regulators forces the organization to act in prudent manner while complying governance requirements as the CGR not only assures that the concept of corporate governance is implemented in letter but also in spirit. Agencies consider whether the codes and guidelines have been followed just for statutory compliance or in substance.

Further, according to the SEBI chairman, this instrument will enable the securities market regulator judge the compliance status of corporations on parameters such as effective creation, management and distribution of investors' wealth. According to him, the damage that resulted out of financial dishonesty can be addressed while it might take more than couple, of generations to compensate the damage caused by intellectual dishonesty. In such situations, a Corporate Governance Rating of the company will provide great assistance to the regulator.

VI. Conclusion

Like everything else in life, Corporate Governance Ratings come with both positive and negative qualities. Some of the disadvantages are as follows:

[n]*Ibid*

Corporate Governance Rating is essentially qualitative and subjective issues, and therefore, may not be easily amenable to clear-cut objective analysis. This also leads to lack of uniformity. Moreover, there could even be some conflict between the interests of the different categories of stakeholders. One of the firms, ISS, has already been criticized for possible conflicts of interest in its rating practice.

While the major rating firms, such as Moody's and Standard & Poor's have developed corporate governance ratings services, they have also been criticized for failure to alert the public of the possibility of unfolding corporate scandals, especially in the case of Enron and also the recent scam of Satyam Computers. Most Corporate Governance Rating limit their scope primarily to the interests of financial stakeholders. Most agencies provide CGR ratings on the formal request of companies and some agencies like Standard and Poor's even provide companies the advantage of keeping such ratings confidential. Thus, the end-effect is that only the good Corporate Governance Rating of a company is made known to the public whereas the unfavorable ones are kept secret. This can greatly mislead the investors and shareholders.

But it is clear from their rising popularity that the stakeholders in the company set great store to such ratings, principally because they reduce the information asymmetry that exists between the management of the company and the other stakeholders and also because they provide an evaluation framework that takes into account both the form and substance of the corporate governance practices that are followed by companies, unlike corporate governance reports of the companies which may not be so forthright in their evaluation.

VII. Recommendations

Recent scandals have shown the poor rating system followed by the CGR agencies, the need is thus to improve the same and take such parameters into consideration which best reflect the Corporate Governance practices of a corporate not only in letter but in spirit. Thus following are the recommendations for the same-

1. They should come up with an accounting standard for the standardization of the parameters for all the credit rating agencies to make an evaluation of the corporate governance practices followed by the company.
2. Corporate Governance Rating is essentially qualitative and subjective, and therefore, may not be easily amenable to clear-cut objective analysis. This also leads to lack of uniformity. Thus, there should be standardization and uniform practice regarding this. Also, a committee of the high officials should be appointed which would evaluate all the present practices of the corporate governance agencies and should devise a mechanism which is to be uniformly practiced by all the agencies and gives all the relevant information.
3. The stock exchanges should collect a fee for corporate governance rating as part of the Listing Agreement from all companies. The stock exchanges can in turn pay the rating agency. This way, not only will the ratings be independent but also the perception that a rating might not be independent because the company pays the rating agency can be avoided. It is also possible to open a fund, where the fee will be collected from the companies and the fund will finance the corporate rating agencies.

4. The information related to the ratings are not appropriately and properly disseminated to the public at large and the investors. Also the ratings and the relevant information, at times is so technical that it is not possible for the investors and public to understand and comprehend them. Thus, there should be a proper mechanism for dissemination of information as well as the information should be made in an investor friendly manner.

Revamping the Existing Code for Internal Auditors: A Necessity for Better Governance

*Kanika Sanwal & Tanvi Sinha**

The role of internal auditors is vital for the successful governance of companies. The scope of auditor's responsibility has increased in this age of corporate governance. This has been due to the increase in the magnitude of operations of the corporations. Informed shareholders, an efficient regulator and numerous regulatory requirements all sharply escalate the probable liabilities faced by the Auditor's of the company.

Auditors play an important role as regards the disclosure of financial information with respect to every phase of working of a company. This financial information influences all the investment decisions of the company. The auditor has an obligation to present the financial statements as per SEBI requirements and other statutory guidelines. Certifying the compliance with corporate governance, certifying promoter's contribution etc., are other areas where the auditor's role is indispensable. Auditors have a critical role in checking financial malpractices by qualifications and effectively disclosing all germane financial information such as mis-utilisattion of funds. Further to ensure transparency in the entire mechanism the role of auditors is indispensable. Hence, the system of governance should be such that the auditors are efficient enough to perform their tasks to the maximum of their capabilities.

In this article, we propose to analyse the responsibilities and liabilities of internal auditors in cases of financial scams and to formulate an ideal code for the working of auditors to prevent any lapse in the system. We aim to achieve this by identifying the loopholes in the present code and incorporating the regulations of different countries to evolve a foolproof system.

* Students, 5th Year, National Law University, Jodhpur

CONTENTS

I. Present Regulatory Framework in India

In India, auditors are primarily regulated by the Institute of Chartered Accountants of India (hereinafter referred to as ICAI), the Companies Act |1956), and the SEBI Act of 1992. The ICAI also sets up ethical, accounting, and professional standards.[1] The auditors are responsible to report and disclose the true financial position of the Company. The auditor should prove that he exercised due professional diligence while discharging his duties and that he was not grossly negligent at any stage of conducting the audit.

ICAI: The ICAI is empowered to cancel or suspend the registration of the auditors in cases of breach of the code of conduct[2], or any other professional misconduct.[3] The method of governance followed by ICAI is that of Self-Regulation as it comprises of professionals of the same fraternity. The Chartered Accountant's Act is not a penal statute and the only sanctions that it can impose are either deregistration of erring members and/or reprimanding them.[4] It has been witnessed that ICAI is seldom harsh on members and metes out punishments quite rarely. There is no provision for auditors to be sued for incorrect auditing as well. The institute's laxity in taking any strict measures against auditors questions the worth of the self-regulatory mechanism.

COMPANIES ACT: The Companies Act requires the auditor to make a report with respect to the financial affairs of the company, to the members of

[1] Section 22 r/w Second Schedule of the Chartered Accountants Act, 1949 :
L.M. Sharma, *"Professional misconduct by Auditors",* 3 Comp.L.J. 81(1992). [3]
Section 8 of the Chartered Accountants Act, 1949 * Section 21(4) of the
Chartered Accountants Act, 1949

the company in general meetings of the company.[5] The auditor also has the additional duty to report to the shareholders whether in his opinion the company has properly kept the books of account or not.[6] An auditor is liable to the members or investors of a company for any loss suffered by them due to the auditor's negligence.[7] The auditor can also be held liable for making any false statement in his report that the balance sheet presents the true and fair view of the company's financial affairs. However, what is shocking to see is that the maximum penalty which can be imposed on Auditors is an insignificant amount often thousand rupees.[9] The procedure for the formation and functioning of audit committees has been laid down by The Companies (Amendment) Act, (2000).[10] Further the Company Auditors Order, 2003 brought under the Companies Amendment Act, 2003, also increased the obligation of auditor. This order imposed on the auditors a duty to maintain greater corporate disclosure.

SEBI: The next important source of conduct of auditors is provided by SEBI. The Naresh Chandra Committee on Corporate Audit and Report played a lead role in reforming the auditor's position in India.[11] Clause 49 of the Listing Agreement requires listed companies to set up audit committee. SEBI lays down the disclosure norms for the companies while submitting

[5] Section 227, the Companies Act, 1956
[6] Suzanie Chua, *The Auditors Liability in Negligence in Respect of the Audit Report,* [1995] J.B.L.l, See Also Paul L. Davies, *Gower and Davies Principle of Modern Company Law,* Sweet & Maxwell, London (2003), p. 583.
[7] Section 227 of the Companies Act, 1956
[8] Section 628 of the Companies Act, 1956
[9] Section 233 of the Companies Act, 1956
[10] Section 292 A of the Companies Act, 1956
[11] Statutes, *"Naresh Chandra Committee on Corporate Audit and Governance"* as quoted in 3 Corporate Law Cases. 199 (2003).
[12] See Corporate Governance in Listed Companies -Clause 49.

their audit report. Auditors, being in a fiduciary relationship with the company[13], are required to submit the correct position of the annual financial statement of the company with SEBI. As opposed to the International scenario wherein auditors have a liability to the market regulators, the case in India reveals the opposite. There is no provision for accountability of the Auditors to SEBI.

In the light of the Satyam scandal, SEBI set up the SEBI Committee on Disclosures and Accounting Standards (SCODA) in Mumbai on January 9, 2009 which recommended that a peer-review of the working papers (relating to financial statements of listed entities) of auditors would be conducted in respect of the companies constituting the NSE - Nifty 50 and the BSE Sensex.

II. Best Practices followed in Other Jurisdictions

The recent Satyam Scandal, a black day in the history of the stock market brought to light the laxity in Indian laws due to which a company like Satyam with auditors like PricewaterhouseCoopers Inc. could get away with such a huge scam for so long, leaving the shareholders and the employees in tatters. This just highlights the carelessness on the part of the law makers in India, not to have taken precautionary steps even after huge financial scams such as Enron and Worldcom. A need thus arises to analyse the laws of various countries to understand the regulatory framework around the world.

[13] R.Baxt, *Modem Company Auditor: A Nineteenth Century Watchdog,* 33 Modern Law Review 413 (1970).

A. United States of America

The consciousness about the role of Auditors in Corporate Governance came to the United States after the huge and complicated financial scam of Enron. Enron was one of the biggest energy companies concerned with energy distribution throughout USA. It declared bankruptcy in 2001 and it was found that it had been sustained for long by systematic fraud.[14] It became synonymous to improper accounting and corporate fraud in 2001. Their recorded profits were inflated and completely fabricated; they created their own related companies to absorb debt and to take the losses from unprofitable entities off their public accounting books.[15]

The various financial scams like Worldcom and Xerox entailed the Enron Scandal leading to the passing of a legislation called the Sarbanes Oxley Act, 2002 (hereinafter referred to as the Act) to introduce various safeguard measures in order to prevent such financial scams.

This Act introduced various standards for auditors; their responsibilities and liabilities were escalated as they were found to have played a major role in these scams. A few striking provisions of the act are that, it mandates the creation of a Public Company Accounting Oversight Board and this board has

[14] W. Steve Albrecht, *Business Fraud (The Enron Problem),* American Institute of Certified Public Accountants, New York, 2005 available at: www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt, *Last Visited on lO"1 March.2009*
[15] Christopher Bowe & Joshua Chaffin, *Problem for All of Corporate America, Knock-on Effects,* Financial Times, June 27,2002; Last visited on 9* March,2009
William S. Lerrach, *Plundering America: How American Investors got taken for trillions by Corporate Insiders,* 8 STNJ L BF 216

17

been empowered with a lot of control over auditing activities. This Act introduced certain provisions for transparency of financial information given out by the company. It mandates the CEO and CFO of each public company to certify the accuracy of information, especially financial information, contained in the company's annual report and other reports filed with the Securities Exchange Commission.[18] It requires each annual report to contain an assessment of the management's internal controls and procedures regarding financial reporting.[19] It imposes a requirement on each company to adopt a code of ethics for senior financial officers.

It provides for the protection of Corporate Whistleblowers and promulgates severe sanctions for obstruction of justice, fraud and retaliation against whistleblowers with potential prison terms extending to 20, 25 and 10 years respectively.[21] It also creates audit committees, which are independent

, 99

and are directly responsible for everything related to the company's auditors. Under the Act^ it is unlawful for any person to fraudulently influence, coerce, manipulate, or mislead any accountants doing the audits for the company. This Act affects all the companies listed in the US and so brings under its umbrella the foreign corporations well, which entails mixed responses.[24] The Federal Sentencing Guidelines are also to be reviewed for enhancement of

[17] Section 101, Sarbanes Oxley Act. This board looks into the audit of public companies, establish audit report standards and rules, and inspect, investigate and enforce compliance by registered public accounting firms. It can alsp impose huge penalties as empowered under Section 105(4) of the Sarbanes Oxley Act. "Section 302, Sarbanes Oxley Act "Section 404, Sarbanes Oxley Act ^Section 406, Sarbanes Oxley Act

[21] Sections 802, 806 and 807, Sarbanes Oxley Act

[22] Section 301, Sarbanes Oxley Act

[23] Section 303, Sarbanes Oxley Act

[24] Robert Charles Clark, *Corporate Governance Changes in the Wake of The Sarbanes Oxley Act: A Morality Tale for Policy Makers Too,* 22 Ga. St. U. L. Rev. 251

fraud and obstruction of justice sentences and for white collar criminal offenses.[25] Therefore, the role of independent auditors has been redrafted to ensure that the corporate accountants reveal to investors the true substance of the deal.[26]

Sarbanes-Oxley addresses, in detail, accountability for corporate and criminal fraud, white-collar crime penalty enhancements, and corporate responsibility.[27] The Act comprehensively provides a strong penal framework, which would force the managers to adhere to the principles of corporate Governance due to fears of sanctions. It has provided a machinery for penalising the white collar crimes effectively, which is much needed in the current political and economic environment anywhere.

B. United Kingdom

According to the law in the United Kingdom, the auditors are primarily held not liable for the detection of any financial fraud. The Companies Act, 1985 in the UK compels auditors, in their contracts with companies, to limit their liability[30]. It also proposes to impose contributory negligence on directors and employers for failure to co-operate with the auditors. The Act

[25] Sections 804 and 805, Sarbanes Oxley Act
[26] Cristina Michelle De Celestino, *Sarbanes Oxley, and Corporate Greed,* 15 U. Miami Bus. L. Rev. 225
[27] Sarita Mohanty, *Sarbanes Oxley: Can one model fit all,* 12 New Eng. J. Int'l & Comp. L. 231
[28] Allen Merrill, *B for Asia Financial Sector,* Business Times , Jan. 18, 2002, Cited from: http://www.bain.com/bainweb/publications/publications_detail.asp?, Last visited on 10th March,2009
[29] Mohammed B. Hemraj, *Preventing Corporate Scandals,* Journal of Financial Crime, 2004, cited as J.F.C. 2004, 11(3), 268-276
[30] Section 310 of the the Companies Act, 1985

also imposes duties in relation to the auditors . Although the primary liability rests with the management of the company, the auditors have a liability to detect serious misstatements in the financial statements leading to a fraud.

According to the Auditing Practices Committee's (APC) guidelines in use England, if an auditor is unable to unveil a fraud, it does not mean that he has failed to perform his duties. However, neither the company nor the auditors, can be condoned for the same.[33] This shows that there are certain duties which are" imposed upon the auditors by virtue of these guidelines. These guidelines encourage the auditors, being in fiduciary duty with the shareholders of the company, to take a proactive role of whistle-blowing. At the same time, it also helps them to maintain the thin line between confidentiality of their client and bringing to light their illegal practices.[34] Hence, in the UK the guidelines for the practitioners emphasize that the job of the auditors is not to detect frauds but to look into financial compliances of a companies.

C. *AUSTRALIA*

The Professional Standards Act, 1994, in Australia tries to limit the auditor's liability for negligence[35]. The Act lays down that auditors are liable to parties who reasonably rely on their reports. The Act provides that the auditors must have a prescribed amount of professional indemnity insurance

" Section 235 of the Companies Act, 1985
[32] Waller, D. (1990) *Auditors Will Have to Become Whistleblowers,* Financial Times, 1st March (8)
[33] *Caparo Industries pic* v *Dickman & Others* [1990] 1 All ER 568
[34] *Supra note 21*
[5] Helen Anderson, *A Different Solution to the Auditors Liability Dilemma,* 8 Bond LawReview.72. (1996)

or have a minimum amount of business assets. Further, it provides for a proportionate distribution of liability between auditors and directors. The task of monitoring and approving schemes which limit the liability falls on the Professional Standards Council which is established under the Regulation.

Australia is currently facing a demand for limiting the liability of auditors. Proposals like capping the amount of liability, reforms to the law of joint and several liability and the introduction of limited liability partnerships are currently some of the most debated topics in Australia.

D. European Union

The European Commission has issued a Recommendation concerning the limitation of auditors' civil liability.[37] The Recommendation leaves it to Member States to decide on the appropriate method for limiting liability. These methods include- cap method, proportionate liability method, etc. The member countries have been given the option to choose any method which suits their legal environment. The Recommendation introduces key principles to be followed by Member States when they select a limitation method, to ensure that any limitation is fair for auditors, the audited companies, investors and other stakeholders.

1. The limitation of liability should not apply in the case of intentional misconduct on the part of the auditor;

[36] Part 6 of Professional Standards Act, 1994

[37] *Commission Recommendation of 5 June 2008 concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms* (notified under document number C(2008) 2274): Cited from http://ec.europa.eu/internal_market/auditing/liability/index_en.htm Last visited on 10th March,2009

2. A limitation would be inefficient if it does not also cover third parties;
3. Damaged parties have the right to be fairly compensated.[30]

III. Comparative Analysis of Laws & Reforms Suggested to Revamp the Code In India

This part of the article focuses on the comparison of the laws of various countries with Indian Laws and brings out the changes which must be incorporated in Indian Law. Though Clause 49 of the listing agreement is a comprehensive regulation which aims at achieving Corporate Governance, it misses out some essential factors which may help in attaining the object of the provision.

A. Regulatory Mechanism

It is necessary that the auditors work in the bests interests of the shareholders of a company. Therefore, they need to be effectively regulated. The Sarbanes Oxley Act of 2002 has led to the formation of a Public Company Accounting Oversight Board (PCAOB)[39] to look into all the auditing practices, and such a regulatory mechanism is very essential for India. The method of self-regulation being followed by the ICAI has failed as stated earlier and multiplicity of regulatory authorities is a major problem in India.[40] Therefore, the powers should be consolidated and vested in one authority for better governance and effective impositions of sanctions.

[58] Ibid
" *Supra Note* 13 at 217
*° N. Vittal, *Issues in Corporate Governance in India* (Paper for publication in the 5th JRD Tata Memorial Lecture Series), cited from http://www.docstoc.com/docs/1021293/Issues-in-Corporate-Governance. Last visited on 10* March,2009

Moreover, ICAI is not an independent body. It ends up being deficient in its duties. This can be remedied by making an independent body like PCAOB.

Another important procedure that should be incorporated in the Indian auditing system is that of dual reporting which is followed in the UK, where the filing is to be done to the independent and the most powerful board (a requirement of which has been mentioned above) along with the market regulator to maintain a dual check. Moreover, some provisions should be introduced through which a company can claim damages from an erring Chartered Accountant in case he is involved in a fraud, as in the UK.[41]

B. Ensure Independent Auditing

The major fault in the system of Governance followed in India is that the auditors are expected to be independent in spite of the fact that they are appointed by the companies themselves. Hence, the element of independence is being compromised with.[42] On the other hand, the Sarbanes Oxley Act of the USA mandates the setting up of an audit committee, which is independent in nature and looks after the appointment of auditors.[43] Therefore, such provisions need to be incorporated for the employment of auditors by a company in India as well. Moreover, according to Section 201 of the Sarbanes Oxley Act, an auditor should not be allowed to perform non-audit functions. Financial audit and consultancy services are to be completely separated from

[41] Virendra Jain, *Debate: Do India's Audit Rules need to be overhauled*, Business Standard, February 4, 2009;
[42] Thomas C Pearson, & Gideon Mark, *Investigations, Inspections and Audits in the Post SOX Environment*, 86 Neb. L. Rev. 43
[43] Section 301, Sarbanes Oxley Act, 2002

each other.[44] This is necessary as auditors charge much higher consultancy fees than the audit or accountancy fees, and become spectators of all the financial manipulations the company does. At times, they even assist the companies in financial manipulations. The auditors face pressure to retain strong clients and hence, they tend to become advocates of their client's financial issues rather than "watchdogs" of their accounts. This goes completely against the role of the auditors.[45] The solution is to provide a mandate under Clause 49 of the Listing Agreement to disallow auditors from acting as consultants or performing any other non-audit functions for the same company.

C. Change in Auditors

It has been observed that the companies which work in consonance with the Corporate Governance principles keep changing their auditors at regular intervals. This has not been followed in India. In the Satyam Scandal, PricewaterhouseCooper had been the auditor of Satyam since the past eight years. This was never questioned.[46] Therefore, a provision can be added either to Clause 49 of the Listing Agreement or in the Companies Act, 1956 to change auditors after a fixed interval of time so as to avoid any malpractice. This can be done in line with the Sarbanes Oxley Act, which provides for the rotation of the lead audit partner every five years[47]. This can also be made

[44] *Independence: "Who Wakes Up the Bugler"'* Accounting Today, December 15, 1997
[45] *Supra F.n. 12*
[46] *Satyam Audit Reports may be deemed unreliable: PwC,* Economic Times, 14 January 2009
[47] Section 203 of the Sarbanes Oxley Act

mandatory, ensuring fair auditing practices in India. This argument is also supported by the Naresh Chandra Committee Report.

D. Whistle -blowing to be made mandatory

While Clause 49 of the Listing Agreement speaks about whistle blowing, it does not make it mandatory. However, the provisions of Sarbanes Oxley Act are different and they encourage whistle-blowing to the extent that they penalize someone who decides to go against the whistleblowers with heavy penalty.[4] Even in the case of the UK, whistle-blowing is encouraged in accordance with the APC guidelines and therefore, for effective corporate Governance and to prevent any further frauds, it is very necessary that whistle-blowing be made mandatory. In the opinion of the authors, it would be efficient to bring out an amendment in the Chartered Accountants Act and introduce a whistle-blowing provision in the code of conduct for auditors to avoid any financial malpractice. The power to regulate the conduct of the auditors must be completely regulated by the ICAI. This should further be complemented by converting the non-mandatory clause for whistle-blowing under Clause 49 of the Listing Agreement to mandatory. However, whistle-blowing is a vulnerable area due to no norms for identity protection, so it should be carefully regulated.

[48] Government of India, *Naresh Chandra Committee Report on Corporate Audit and Governance*, (Ministry of Finance, 2002)
[49] Section 806, Sarbanes Oxley Act

IV. Conclusion

The present economic scenario in India attracts immense growth opportunity for companies, with huge scandals of the magnitude of Satyam staring in the face. Therefore, along with growth what is important is sustainable growth so that investors do not lose faith in corporates. Hence, we have suggested a better regulatory framework for the regulation of auditors, incorporating best practices of various jurisdictions, as the current regulatory system is inadequate in light of the pace of growth of the economy. We have provided a framework encouraging proactive conduct, accountability, sanctions and sincere application of laws for the fair success of a company, thereby, building a stronger economy.

Role of Civil Society in Improving Governance

*Raghav Dhawan & Shuchita Bhushan**

The role of effective governance is vital with regards to non-profit organizations (NPO) considering their continuous rise in size and importance of late. The Board's role in the management of the organization is evolving and their contribution is pertinent for meeting their goals successfully. Since most of the funding provided to the NPOs come from external sources, transparency and accountability are of prime relevance. The governance mechanism is brought into force to ensure that the work done, especially at the grass root level, is duly evaluated and can stand public scrutiny. This will allow the authenticity of their work to be adjudged thereby guaranteeing continued funding by the public

The principles of corporate governance have been implemented in the for-profit sector in the recent past. However, the specific character of the non profit sector, i.e. goal structure, specific configuration of ownership rights, multi-stakeholder character, resource mix, culture, makes it difficult to implement these principles directly. They have to be adapted to fit the unique structure of NPOs. Though researchers have been grappling with this issue a formalized framework is yet to be developed. The most frequent application of the principles of governance with respect to the NPOs is the establishment of the Board but other mechanisms are also being developed.

The article will address the issues of the lack of a formal model of governance for the non profit sector and also discuss the importance of effective governance of NPOs especially in the Indian context. Such a model is of key importance in India due to the large number of NPOs operating at grass root levels with the nation's underprivileged population. These need a more effek '.ive governance to be able to perform their functions more effectively and yet maintain a high degree of accountability.

* Students, 5th Year, National Law University, Jodhpur

CONTENTS

I. Governance

A. Overview

Governance, with respect to business or even a non-profit organization refers to cohesive policies, consistent management and well defined processes and decision making with regards to the running of the organization. The United Nations Economic and Social Commission for Asia and Pacific (UNESCAP) defines "governance" as: *"the process of decision-making and the process by which decisions are implemented (or not implemented)*." Therefore, the study of governance involves a study of thojs who are involved in decision making. UNESCAP also gives good governance 8 major characteristics. It is participatory, consensus oriented, accountable, transparent, responsive, effective and efficient, equitable and inclusive and follows the rule of law. Good Governance, with respect to the non profit organizations or the non governmental organizations, means effective management of NGO resources in a manner that is transparent, accountable and responsive to people's needs.

B. Governance in non profit sector

There are a number of Non-profit or Non-Governmental Organizations functioning these days in both International as well as national levels. India is estimated to have between one million and two million NGOs. Major sources of funding in these organizations include membership dues, the sale of goods

[1] http://www.unescap.org/pdd/prs/ProjectActivities/Ongoing/gg/governance.asp last visited on January 12, 2009

[2] "What is an NGO?" (last modified January 5, 2007), <http://www.indianngos.com/ngosection/newcomers/whatisanngo.htm>

and services, grants from international institutions or national governments, and private donations. The governments of the countries where such an organization works or is registered in may require reporting or other monitoring and oversight. Funders generally require reporting and assessment, such information is not necessarily publicly available. There may also be associations and watchdog organizations that research and publish details on the actions of NGOs working in particular geographic or program areas.

The main aims of non-profit organization or non governmental organization is to help better quality of life in all its realms through community mobilization, participatory governance based on sustainable natural resource management. Given the growth of non profit organizations in the recent past, both in size and in importance, issues regarding their governance have come under scrutiny. Over the last decade or two, there has been increasing interest in the composition, conduct, and decision-making of non-profit governing boards. The board-staff relationship has been at the centre of the discussion, but trustee characteristics, board role in planning and evaluation, committee involvement, fiduciary responsibility, legal liability, and other topics have received their share of attention.

The governance function of a non-profit is responsible to provide overall strategic direction, guidance and controls. Often the term "governance" refers to board matters. However, many people are coming to consider governance as a function carried out by the board and top management. Effective of governance depends to a great extent on the working relationship between board and top management.[3]

Carter McNamara, *Basic Overview of Nonprofit Organizations*, - np://managementhelp.org/org_thry/np_thry/npjntro.htm, visited on January 12, 2009

The role of effective governance is vital with regards to non-profit organizations (NPOs). Since most of the funding provided to the NPOs come from external sources, transparency and accountability are of prime relevance. The governance mechanism is brought into force to ensure that the work done, especially at the grass root level, is duly evaluated and can stand public scrutiny. This will allow the authenticity of their work to be adjudged thereby guaranteeing continued funding by the public.

II. Importance of Governance

We have been a witness to a number of corporate collapses in the past decade. Be it the Enron scandal or closer home the Satyam episode. The list of Board failures also includes much of the savings and the loan industry especially in the US which has been riddled with unscrupulous practices and unwise lending policies. The Non Profit sector has also been embroiled in controversies.[4]

Transparency and good governance are imperative for developing the credibility of non-profit sector. Without enhancing public trust in non-profits this increasingly valuable and vibrant sector is going to stay under utilized. Academic literature indeed argues that governance is more important among nonprofits than for profits. It has been argued that the lack of an active ownership market among non-profits accentuates the role of internal

[4] Margaret Gibelman and Sheldon R. Gelman, *"Very Public Scandals: An Analysis of How and Why Nongovernmental Organizations Get in Trouble,"* paper presented at the International Society for Third-Sector Research at the Fourth International Conference, Dublin, Ireland, July 7, 2000, http://www.istr.org/conferences/dublin/workingpapers/gibelman.pdf, visited on January 12, 2009.

governance practices among nonprofits.[5] It has also been argued that the complexity of the products and services created by the typical non-profit and the lack of a simple metric like profitability as a performance measure also put pressure on the governance skills of the non-profit board.

Moreover, adopting of good governance practices is of prime importance in the non profit sector to minimize the inconsistency between development of professionalism in NPO/NGO sector and charitable nature of this sector. Organizational development can be facilitated by building capacities of NPOs/NGOs to be strategic and effective through training leaders and key managerial personnel.

III. Problems of Governance in NPOs

While the Corporate Sector has attempted, and to some extent, succeeded, in institutionalising better governance practices, the Voluntary Sector or the non profit sector has unfortunately lagged behind. Increasingly however, the need for *'good governance'* is also being felt in the not-for-profit Sector. The principles of corporate governance have been implemented in the for-profit sector in the recent past. However, the specific character of the non *profit sector, i.e. goal structure, specific configuration of ownership rights,* multi-stakeholder character, resource mix, culture, makes it difficult to implement these principles directly. They have to be adapted to fit the unique structure of NPOs.

[5] Eugene Fama and Michael Jensen, Separation of Ownership and Control, *Journal of Law and Economics*, June 1983, 301-26. *c/f* Millstein, O'Regan and Sharon Oster (eds.), *Governance Practices Among Nonprofit Organizations Contracting with New York City,* Yale School of Management, Working Paper Series E, Working Paper # 8, September 2000.

Ensuring the accountability of non profits involves first of all creating the conditions which will allow for open expression of views, free dissemination of information and the rule of law which is essential to the effective functioning of every NGO. These organizations are now being challenged and have been made to address issues concerning their accountability and representatives.

The key questions being asked are:

- To whom are NGOs accountable?
- Who or what do they represent?

Many non profit boards consist of voluntary directors who serve without pay. Such volunteer directors often believe they serve in an honorary and passive capacity. They believe they lack the authority to do anything but advise, counsel and approve. Rarely do they question, challenge, or oppose management when necessary. Yet, who do they serve when they give advice or counsel? Unfortunately, many directors mistakenly think they serve the organization's chief officer rather than the organization itself. They do not seem to realize that they are organizational governors who have certain predefined responsibilities.

Even in the for profit sector, many of the corporate collapses can be blamed on board failure since many times the directors either are unaware of actual state of affairs in the organization which the management keeps from them or they simply believe that the it is the management that is accountable and not them. Sadly, these problems are more in the non profit sector where in fact good governance is of the similar, if not more importance, as in the corporate sector.

IV. Governance Principles for NPOs

The Following are certain basic principles that are of vital importance to promote the effective governance of NPO's:[6]

1. The board of directors of a non-profit corporation must engage in active, independent, and informed oversight of the activities of the corporation, particularly those of senior management.
2. Directors with information and analysis relevant to the board's decision-making and oversight responsibilities are obligated to disclose that information and analysis to the board and not sit passively. Senior management should recognize and fulfil an obligation to disclose - to a supervising officer, to a committee of the board, or to the board of directors - information and analysis relevant to such person's decision-making and oversight responsibilities.
3. Every non-profit corporation should have a nominating/governance committee composed entirely of directors who are independent in the sense that they are not part of the management team and they are not compensated by the corporation for services rendered to it, although they may receive reasonable fees as a director. The committee is responsible for nominating qualified candidates to stand for election to the board, monitoring all matters involving corporate governance, overseeing compliance with ethical standards, and making recommendations to the full board for action in governance matters.

[6] Thomas Silk, Ten Emerging Principles of Governance of Nonprofit Corporations and Guides to a Safe Harbor, Volume 7, Issue 1, *The InternationalJournal ofNot-for-Profit Law*, November 2004 available at ^http://www.icnl.org/knowledge/ijnl/vol7issl/art_3.htm> visited on January 12,2009.

4. Every non-profit corporation with substantial assets or annual revenues should develop and implement a three-tier annual board evaluation process whereby the performances of the board as a whole, each board committee, and each director are evaluated annually. The board should also develop and implement a process for review and evaluation of the chief executive officer on an annual basis.
5. Each board of directors is responsible for overseeing corporate ethics. Ethical conduct, including compliance with the requirements of law, is vital to a corporation's sustainability and long-term success. To establish an ethical corporate culture, the board should consider the following actions:
   - communicate to personnel at all levels of the corporation a strong, ethical "tone at the top," set by the board, the chief executive officer, and other senior management, establishing a culture of legal compliance and integrity;
   - assign to the chief executive officer or other officer the specific task of serving as compliance officer;
   - adopt a Conflicts of Interest policy;
   - include ethics-related criteria in employee qualification standards and in employees' annual performance reviews.
6. Every non-profit corporation with substantial assets or annual revenue should be audited annually by an independent auditing firm. The corporation should change auditing firms or the lead and reviewing audit partner periodically to assure a fresh look at the firm's financial statements.

   The audit committee should be composed of completely independent directors and should set rules and processes for complaints concerning accounting and internal control practices. It is responsible for hiring, setting compensation, and overseeing the auditor's activities.

7. The chief executive officer and the chief financial officer of every non-profit corporation should review any annual information returns filed by the non-profit organization with the authorities.
8. Any law practitioner providing legal services to a non-profit corporation who learns of evidence that the practitioner reasonably believes indicates a material breach of fiduciary duty or similar violation should report that evidence to the chief executive officer of the non-profit corporation and, if warranted by the seriousness of the matter, to the board of directors.
9. Every non-profit corporation should adopt a written policy setting forth standards for document integrity, retention, and destruction.
10. Every non-profit corporation should adopt a written policy to permit and encourage employees to alert management and the board to ethical issues and potential violations of law without fear of retribution.

V. A Comparison of the Indian and Chinese Approaches

At present the two fastest growing economies are India and China, these two can be considered as the engines of economic growth today, and even with the global recession are still showing comparatively healthy growth rates. The problem that arises is that with regards the industrial sector rapid development has taken place and numerous structural changes have accordingly been incorporated into the sector to compensate for the same. This had the ultimate effect of allowing for a more professional approach to allow for the organisations to be brought into conformity with global standards. A similar analogy can be seen for the Non Profit sector. Besides the rapid economic development in the nations there is still a wide disparity in the populations. It is for this reason that global standards need to be incorporated in the non profit sector also to allow for its effective development. Moreover, both nations have very divergent approaches with regards their regulatory systems, thus a comparison of these two nations will put forward their respective distinct approaches to a similar issue.

A. The Indian Scenario

In India, even the right to participate in NGOs and the types of NGOs are specifically laid out in the Constitution.[7] Often Indian NGOs provide services for a fee while working as a contracted service provider acting as a liaison between service users and private sector providers; or as collaborators between the government and the private sector advising on policy; social innovators; playing the role of social critic and public advocate; or building institutes that provide welfare services. Thus, Indian NGOs almost functions on the same level as government agencies with the office of charity commissioner or other registration institute governing them. Accordingly, the government institutes all aspects of operation from establishment, to funding, from tax requirements and tax benefits, to the handling of foreign donations. However, most laws or acts governing NGOs are relatively lenient except for those governing foreign donations and the activities of the Foreign Contribution Regulations Act of 1975. It requires an organization to go through several steps in order to receive contributions and basically acts as a tool of the Home Ministry to bring NGOs in line. However, here again, as in the case with Bangladesh laws governing the management of boards which

'Articles 19(l)(c) and 30

should act as the main vehicles for governance, legal mandates are outdated and need revisions in order to make them functional tools of governance. The Indian government, recognizing the need for better governance in NGOs, have set up a 5-year plan to encourage Indian NGOs pursue good governance. They have plans to make amendments to the constitution to create legal bodies to help accelerate democratic decentralization of governance; encouraging increased public participation; reforming the revenue system; and assuring the right to information.

Efforts towards self-governing are seen in the formation of Credibility Alliances which calls NGOs to voluntarily abide by standards to promote norms in the sector through registration. The ultimate goal of these credibility alliances is to act as nodal agencies in the sector . They have called individual organizations to state clear objectives and make a commitment to practicing good governance. It is an initiative by a collective of voluntary organisations committed towards enhancing accountability and transparency in the voluntary sector through good governance. CA was registered in May 2004 as an independent, not-for-profit organisation after an extensive consultative process over a period of two years involving thousands of voluntary organisations all over India[9]. Other organizations in the sector, such the GIVE[10] (Giving Impetus to Voluntary Effort) offers consultation and assistance to NGOs on how to raise funds and promote transparency and good governance. In terms of utilizing technology, only a few organizations utilize

[8] http://www.credall.org.in/about_us/faq.htm last visited on January 13, 2009 '
http://credibiliryalliance.org/general.htm, visited on January 13, 2009

[:0] Choudhury, Enamel and Shamima Ahmed, 2002. "The Shifting Meaning of Governance: Public Accountability of Third Sector Organizations in an Emergent Global Regime", Vol.25(14), *International Journal of Public Administration*, 561-589.

contemporary technology to facilitate communication, documentation and awareness of the work that NGOs do.

B. The Chinese Scenario

The Chinese government's response to the growing role of NGOs in democratic governance has been lukewarm at best. As the government and its state-owned enterprise sector can no longer bear the full burden of tackling growing societal problems, it began to rely on social service groups to offer services to the needy under the auspices of the Ministry of Civil Affairs. In addition, the transition from a planned economy to a 'pseudo' market economy meant that social welfare services that were plentiful in the old system need to be cut back. The government is experimenting with a contractual or delegation approach in terms of allowing community organizations and social organizations to take on more responsibilities in this area. China seems to be cautious about any form of political activity by NGOs by strictly enforcing regulations. In addition, a series of cases of misappropriation of funds have discredited NGOs, prompting the government to put in place fiduciary monitors for GONGO (government funded NGOs) and grassroots organizations. Although the regulatory framework surrounding NGOs is still in early phase of development, the Chinese government has sought to secure fiduciary responsibilities and public accountability from the NGO sector.

A two-fold system makes up the administrative and regulatory framework for China's NGOs. Agencies must register with the Ministry of Civil Affairs and must have a separate registration and administrative internal bodies responsible for management. Governing boards exist but their roles are also highly restricted by the government which selects 60% of the members and are required by law to hold regular meetings." Issues regarding the internal governance in Chinese NGOs arise at the academic level and thus resulting in the pursuit of initiatives seeking to promote accountability and good governance through research and training. One such effort is the collaboration between the conference of government agencies and the president of Evangelical Council for Financial Accountability. In addition, the Chamber of Congress set forth detailed rules for foundation administration.

VI. Suggestions

The non profit or non governmental organizations can improve their governance and operations by adopting the following guidelines :

- Stating their mission, values and objectives clearly and ensuring that their strategies and operations are at all times within them;
- Better management processes as well as financial management, accounting and budgeting, systems;
- Better human resource development and training within the organisation-of managers, administrators, project staff, board members, beneficiaries, members and volunteers;

"Ku-Hyun Jung, Park Tae-Ku, and Chang-Soon Hwang, *"Korea" c/f* Thomas Silk(ed), *Philanthropy and Law in Asia: A Comparative Study of the Nonprofit Legal Systems in Ten East Asian Societies* (San Francisco: Jossey-Bass Publishers, 1999) .

[2] Thomas Silk(ed), *Philanthropy and Law in Asia: A Comparative Study of the Nonprofit Legal Systems in Ten East Asian Societies* (San Francisco: Jossey-Bass Publishers, 1999)

[3] http://www.vaniindia.org/Reports/Good%20Governance%20and%20NGOs.ppt, visited on January 12, 2009

- Better procedures to ensure that men and women have equal opportunities to participate effectively at all levels of the organisation, from members to leaders;
- Better means by which both the organisation, and its projects, services and activities are monitored, evaluated, and reviewed;
- Consistent efforts towards capacity building and evaluation of human resources;
- Ensuring absolute independence of auditors;
- Stratified participation from the grass root;
- Evaluation in terms of the objectives achieved rather than amount of funds utilized;
- Implementing systems which are essential though not legally mandatory;
- Better information provision by and about NGOs;
- Better networking and alliance-building among NGOs.

Some of these guidelines have been seen in practice but a more widespread and consistent usage will definitely result in better accountability levels in the non profit sector.

The organization must definitely avoid:

- Weak Governance, Leadership and Management
- Abusive Leadership and Management
- Vague Strategic Decision
- Unclear Roles and Responsibilities
- Unclear Expectations

VII. Conclusion

As a process, governance may operate in an organization of any size: from a single human being to all of humanity; and it may function for any purpose, good or evil, *for profit or not.* A reasonable or rational purpose of governance might aim to assure, (sometimes on behalf of others) that an organization produces a worthwhile pattern of good results while avoiding an undesirable pattern of bad circumstances. In terms of the non profit sector, which functions mainly on outside funding, the need for good governance practices in unquestionable to preserve their credibility. Most NGOs are funded by international donors, which make specific accountability/evaluation demands. The NGOs' employees, board, and constituents are also significant stakeholders. As an NGO grows in size and scope it faces the challenge of trying to balance its liabilities to its donors, and other stakeholders, as well as retain the organization's creativity and flexibility.

It is important to realize and act upon the notion that good governance is ultimately important to not only for the sustainable growth of the NGO sector but also to maintain public trust in civil society. To this end, the governments and NGO sectors have made concerted efforts to shore-up internal governance and organizational effectiveness of NGOs. It is also important to realize that reforming NGO internal governance mechanism must be based on long-term perspective and one that is linked to their organizational mission and client service. To this end, although self-regulation on the part of the NGO sector is critical in the success of securing internal accountability of NGOs, the strategic partnership between the state and the NGO sector is also a key component. Because civil societies in the region are said to be early in the phase of development, instituting an enabling environment without much heavy-handedness of the state will be critical to the 'institutionalization' process, which include both internal governance structures as well as management schemes.

Revising Self Regulation as a Mode of Corporate Governance: Regulator as Promoter of Self Regulation

*Ambiecka Pandit & Roopal Banthia**

It has long been believed that corporate self-regulation offers significant advantages for reducing unlawful or unethical corporate behavior over the alternative of increased direct governmental regulation of corporate activities. It is this point where corporate responsibility and governance intersect. The law is limited in its ability to regulate business behavior in situations where the cost of enforcing laws may be too great, or the enforcement of laws would require the violation of higher values in the society, or ethical standards or norms for behavior cannot be easily translated into objective, judiciable, legal standards.

Developing concept of Self regulation is a reflection of the global market which is going through transition. State is withdrawing from the market as a regulator, promoting deregulation and dissolving barriers. The limited jurisprudence of self regulation draws from the principle of positive and negative incentives as motivating factors. The objective of the article is to review the recommendations of the Cadbury committee and the J.J. Irani committee on self regulation in corporate governance and suggest a proposed model befitting the Indian scenario. Part I covers the existing jurisprudence of corporate governance in our country. Part II highlights self regulation as a mode of corporate governance. In light of inapt enforcement of regulations and existing working model of self regulation, the article in part III suggests the designing of a successful system where in the regulators promote self regulation thereby striking a balance between open market freedom and state intervention. The proposal has been justified in the context of the current Indian corporate sector so as to establish its relevance.

Students, 4th Year, National Law University, Jodhpur

CONTENTS

I. Jurisprudence of Corporate Governance in India: Committee Recommendations on Corporate Code of Conduct

Corporate governance is a terminology that came in vogue with increased stakeholder awareness and changing market scenario. Corporate governance is the process by which corporations are made responsive to the rights and wishes of stakeholders.[1] The concept of Corporate Governance process may be helpful because it emphasizes the continually changing nature of expectations which boards have to meet, while the issue of who are the stakeholders and what are their rights is variable.

The basic governance issues are power and accountability. They involve where power lies in the corporate system and what degree of accountability there is for its existence. The balance of power within the corporate system is continually shifting and it is these changes especially in relation to shareholder owned companies which bring governance issues to the fore.

Currently in India corporate governance is ineffective. It remains more a concept on paper than in practice. This is not only due to poor enforceability but also inapt methods of governance. It came to the fore front after the Cadbury Committee made recommendations on corporate governance in the United Kingdom. This sparked debate on the value framework, the ethical framework and the moral framework under which business decisions are taken. In the Indian context, the need for corporate governance has been

' Demb and Neubauer, *The Corporate Bond: Confronting the Paradoxes Adrian Cadbury, Corporate Governance and Chairmanship A Personal View* (Oxford University Press, New Delhi, 1st ed, 2003) highlighted because of the scams occurring frequently since the emergence of the concept of liberalization from 1991. We had the Harshad Mehta Scam, Ketan Parikh Scam, UTI Scam, Vanishing Company Scam, Bhansali Scam and so on. In the Indian corporate scene, there is a need to induct global standards so that at least while the scope for scams may still exist, it can be at least reduced to the minimum. The corporate governance code proposed by the Confederation of Indian Industry is modeled on the lines of the Cadbury Committee (Cadbury, 1992) in the United Kingdom.[3] It recommended that boards of publicly-traded UK corporations include at least three outside directors and that the positions of the chairman of the board and chief executive officer not be held by a single individual. The underlying presumption was that these government-sponsored recommendations would lead to enhanced board oversight.[4] In other words, it implied the separation of management from ownership.

In the backdrop of legislative and regulatory change brought about by the revised clause 49 of the Listing Agreement and the JJ.Irani Committee report on corporate governance what is lacking is a model that can be implemented. Clause 49 of the Listing agreement was modified post the Narayana Murthy Committee report which was set up by SEBI, under the chairmanship of Mr. N. R. Narayana Murthy, to review Clause 49, and suggested measures to improve corporate governance standards. Some of the

[2] http://www.indiacorporateadvisor.com/docs/cgindia.asp

[3] *Ibid*

[4] Jay Dahya, Nickolaos G. Travlos and John J. McConnell, *The Cadbury Committee, Corporate Performance and Top Management Turnover,* www.mgmt.purdue.edu/centers/ciber/publications/pdf799-004.pdf, <visited on March 12, 2009>

major recommendations of the committee primarily related to audit committees, audit reports, independent directors, related party transactions, risk management, directorships and director compensation, codes of conduct and financial disclosures.

J.J Irani Committee Report followed in line with the many guidelines that came earlier and recommended the amendment of the Companies Act. Broadly the objective of the review was to retain desirable features of the existing framework, segregate substantive law from the procedures to enable a clear framework for good corporate governance that addresses the concerns of all stakeholders equitably; revise the law so as to enable a compact statute that is amenable to easy understanding and interpretation.[6] However, it was succinct in pointing out that legislative reform alone would not help our cause and it needs supplementation by regulatory and professional bodies whose role was left undefined. It mentioned in passing small industries and them deserving need for differential treatment and brushed through the issue of time limitations and subsequent need for more tribunals. The Committee pointed that the system of self regulation contemplated by the Companies Act in section 372 in relation to inter corporate investment is not effective and requires a system of check and balance to increase its viability.

Most Committees recommended only legislative and regulatory reform with little emphasis on self regulation as a tool of governance. The National

" National Foundation for Corporate Governance, *Discussion Paper -Corporate Governance in India: Theory and Practice*, (NFCG, 2004)
Government of India, *Report: J.J Irani Committee on Company Law* (Ministry of Company Affairs, 2005)

Foundation on Corporate governance was of the opinion that mandatory legal sanctions should be minimal and voluntary compliance and self regulation should buttress the same.[7] The recently proposed heightened degree of desired conduct by the Confederation of Indian Industry (CII) is mere guidelines which lack incentives for enforceability. Like the many other directives of corporate ethics and transparency they remain attractive in theory.

II. Self-Regulation as mode of corporate governance: Importance and Relevance

Developing a system of Self regulation is in the interest of a cost effective yet efficient supervision to. strengthen corporate governance with least interference from the government and regulators. In fact, apart from deviations now and then, the principles of self regulation have worked effectively especially in the securities markets in the past. * °

The recent scams and scandals have emerged mostly because the corporate have managed to identify loopholes in the existing system and circumvented the compliance norms and enforcement of self regulatory mechanisms. Besides, adopting a well laid self regulatory mechanism would further eliminate delays due to routine and complicated procedures and the limitations of bureaucracy which the company officials and members may be subjected to.[9]

'*Supra* note 6

[8] Sam S. Miller, *Self-Regulation of the Securities Markets: A Critical Examination,* 42 Wash. & Lee L. Rev. 853,: 856 (1985)

[9] Jonathan R. Macey, *Options for Future Regulation of Financial Planners*, Part II, 15 J. Fin. Plan. 90 (2002).

With rapid globalisation and constantly changing economic environment, most of the govermnent regulations face *the threat* of becoming outdated and irrelevant but cannot be repealed away without substantial time lag. Self-regulation is capable of meeting the requirements of flexibility.[10]

Besides, it is more convenient to seek compliance in case of rules framed for oneself in comparison to those imposed from the authorities. Self regulation would be more comprehensive and practically suited as per the needs of industry with regards to regulatory concerns." Not disregarding the importance of regulators like SEBI in the securities market and its reasonably well achieved objectives, it is also necessary to understand that proper implementation of regulatory control cannot come without an effective internalisation process which spreads within the corporate organisation becoming a part of its existing culture. The establishment of a regulator to be involved with all aspects of corporate behaviour would involve an enormous bureaucracy, it is necessary to design a legal framework which establishes a form of directed self-regulation within companies.[12]

The debate about the merits or demerits of self-regulation was given renewed impetus by the appearance of the Cadbury Report in 1992, but by 1995, evidence was beginning to emerge of significant levels of compliance with the Cadbury Code, albeit with lower levels among smaller companies.

"° Steven M. H. Wallman, *Competition, Innovation, and Regulation in the Securities Markets*, 53 Bus. Law. 341,356(1998) [1] Ernest E. Badway and Jonathan M. Busch, *Ending Securities Industry Self-Regulation As We Know It*, 57 Rutgers L. Rev. 1351 (2005)

[12] *Ibid*

[13] A. Belcher, *Regulation by the Market: The Case of the Cadbury Code and Compliance Statement*, J.B.L. 321 (1995)

Enforcement mechanisms, while not as final and crushing as legal enforcement, can nevertheless be very varied and create a supportive environment for a self-regulatory code.[14]

III. Enforcing Self Regulation: A proposed model

Self Regulation as a mode of governance is in its nascence in India. Most Committee reports that have opined on corporate code of conduct have suggested self regulation as the ideal mode of ensuring corporate governance given voluntariness and flexibility are its characteristic features. These are essential to ethical behavior considering companies are profit making enterprises. However principles like this are lofty and ideals like this lacking enforceability. Self Regulation is not a concept alien to India. It has been long contemplated by the market regulator SEBI, which has incorporated the power to formulate self regulatory organizations in section 11 (2) (d) of the SEBI Act, 1992. The power of these organizations is left to the discretion of the SEBI. Currently four such organizations exist in our country, all functioning with tremendous ease and success.[15] These are Association of Merchant Bankers of India (AMBI), Association of Mutual Funds of India (AMFI), Association of Custodial Agencies of India (ACAI), Registrars Association of India (RAIN). Their role does not include corporate governance but they help meet objectives like investor protection, streamlining activities, facilitation of services etc.

What we propose is *directed self regulation.* This is a variant of the above concept of self regulation. Instead of each company setting its own

[15] Securities Exchange Board of India, *Annual Report* (SEBI, 1996-97)

standards of regulation, the standards or aim of the regulation is defined.[16] It is a product of the newly developing 'deregulation' where in the state is attempting to withdraw as the direct agent of command and control and public management, in favour of being an indirect regulator of internal control systems in both public (or formerly public) and private agencies".[17] Detailed implementation is left to individual companies so that the mechanisms which suit that company may be established. While directed self-regulation lacks the flexibility of avoiding over strict rules for small enterprises, it shares with enforced regulation the benefits of individual design of rules so that companies are likely to be more committed to them, hostility to outside regulators is avoided and the confusion of two rulebooks is avoided.[18] Self regulation can thus be effective if pursued diligently through a system of incentives. The system has to be so designed that self regulation is imbedded and promoted.

The proposed Model has the following three essential features:

1. Industry guidelines on corporate conduct and mandatory adoption of a code of conduct by every company to work on principle peer pressure.
2. Negative and Positive Incentives to motivate compliance.
3. Self Regulatory Organizations to promote regulation.

A. Industrial Guidelines

The biggest drawback of the much discussed self regulation system is its inability to be enforced. A voluntary code to be subscribed to like this requires some incentive to make it adoptable. In the absence of such motive it

[16] ***Supra* note 12.**
[17] *Ibid*
[18] Vanessa Finch, *Corporate Governance And Cadbury: Self-Regulation And Alternatives,* **J.B.L. 51(1994)**

remains a vague philosophical virtue. In order to make it a functional moc corporate governance certain factors can be used as tools to make weight? proposition of self regulation. The principle of mutual dependent symbiosis can be employed to meet these objectives. If the broad-guide under which such a code of corporate conduct is to be formulated is r industry wise, entities like peer surveillance and good will can be use pressure a company's compliance to the code. We suggest that each indi makes a personalized set of guidelines/ framework for companies fa under it to devise and adopt a code for corporate conduct made by them w the ambit of the framework laid down by the industry. The formulation c appropriate code will become industry subjective and good will amongst companies in the industry will serve as an incentive to comply with adopted code. If a company fails to adopt they stand to lose the trust rep in them by the other companies .which is essential to a company which si a symbiotic relation with other companies in the same industry. Thus, a for corporate governance would be mandatory but it can be made by*e company autonomously keeping its features and interests in mind. The cc company- gives to itself will require approval by the Self reguk organization to ensure governance is not reduced to a sham. At present, cl 49 of the listing agreement requires a quarterly compliance report to er supervision of compliance with the code of conduct. However the repc accepted and there is no system to check its authenticity. The schem governance in clause 49 is such that companies are placed under

[19] Antonio Vives, *Corporate Social Responsibility: The Role Of Law And Markets,* 83 Kent L. Rev. 199(2008)

'° Dilip Kumar Sen, *Clause 49 of the Listing Agree* www.icai.org/resource_file/10980dec04p806-811 .pdf, <visited on March 10, 2009>

surveillance of SEBI and the stock exchange making regulation dispersed and fragmented.

B. Incentives

No system is effective without an enforcement strategy and in the absence of one currently self regulation remains a philanthropic concept. Enabling regimes can encourage compliance in the long term through incentives. They can be positive and negative. This serves as a motivating factor to attract compliance. As more and more firms adopt corporate governance practices, over time these voluntary practices can become the norm among a majority of firms. In year one of its inception, relatively few firms may cqmply with a voluntary code. Over time more and more firms may comply, believing that they will lose investors or be outdone by their competitors (because of "peer pressure") if they do not. This peer pressure effect is a pure market mechanism that can occur without mandatory legal rules.[21] This is an instance of negative incentive. Legal sanction constitutes another example of negative incentive. Examples of Positive incentives include rewards for compliance and awards as gestures of encouragement. The ICSI National Award in place for excellence in corporate governance is one such positive incentive.

To bring the element of effective implementation we suggest the doctrine of absolute liability be imported to violations of the code for corporate conduct. The doctrine translates to no defense being available for

[21] Anita Indira Anand, *An Analysis Of Enabling Vs. Mandatory Corporate Governance: Structures Post-Sarbanes-Oxley* 31 Del. J. Corp. L. 229 (2006)

breach of a duty of care. To justify the use of this doctrine two points need to be looked into :

1) Gravity of consequences of breach
2) Need of compensation

The doctrine is now in use in environmental jurisprudence[24] in India. The only rationale for its adoption was that environmental hazards have a long lasting effect and liability can be easily escaped using intervening factors as defense. In light of the above it became difficult to accord liability and hence fix a source for compensation which is indispensible in the ends of justice. Similarly, corporate conduct is a loose framework, vague and subjective. It is very easy to escape liability using lacuna in the law. The effect of a slip in compliance is dire as a lot of public money is at stake. As investor trust is shaken, the securities market is gravely affected. Both requirements of absolute liability are thus met and its use justified in this case.

For increasing legal and self governance reasons, voluntary disclosure of corporate affairs would strengthen the system of self regulation. In many American corporations, internal investigations are continuously being undertaken by corporate executives as an essential part of responsible self-governance. The federal agencies in US have created additional incentives to conduct internal investigations by encouraging voluntary disclosures of

[22] Maragaret R. Brazier, *Clerk andLindsell on Torts* (Sweet & Maxwell, London, 14th e.d,)
[23]Murphy and Burgess, *NSW Legislation Review Committee Inquiry into Strict and Absolute Liability*, www.nswccl.org.au/docs/pdf7StrictLiability.pdf, visited on March 11, 2009 [24]*Vellore Citizen Welfare Forum* v. *Union of India* AIR 1996 SC 2715

wrongdoing by corporations.[25] The Securities Exchange Commission offers Formal voluntary disclosure programs encouraging corporations to investigate non-compliance and report the results to the Securities Exchange Commission by recognising the mitigating effect of such disclosures on the ultimate penalty.[26]

Taking a cue from the voluntary disclosure schemes under the Securities Exchange Commission in United States, positive incentive of self regulation can be determined. If the companies adopting the codes of conduct containing self prescribed rules and regulations happen to not comply with them due to negligence of any member of the company; the company should voluntarily report this non-compliance within a period of one year to SEBI (the degree of reduction of penalty would be dependent on the promptness of the disclosure, sooner the non-compliance is reported the lesser the penalty). Besides, such disclosure would be kept confidential as between SEBI and the company. Thus, the voluntary disclosure of non-compliance would benefit the company (any company defaulting its own code) in terms of reduction of penalty and no criminal prosecution against the directors and members not directly involved in the violation.

C. *Self Regulatory Organisations*

Since we propose the market regulator as a promoter of self regulation we have designed their role as supervisory to that of a self regulatory

~ **Richard H. Porte,** *Voluntary Disclosures To Federal Agencies—Their Impact On The Ability Of Corporations To Protect From Discovery Materials Developed During The Course Of Internal Investigations,* 39 Cath. U. L. Rev. 1007 (1996) *" Janet Dine, *Discovery of Internal Corporate Investigations,* 32 Stan. L. Rev. 1163 (1980) organization. In 2004, SEBI issued the Self Regulatory Organization Regulations providing for formation recognition and functioning oi voluntarily formed self regulatory organizations. These are non profil companies under Section 25 of the Companies Act. Regulation 22 provides that the SEBI may direct self regulatory organizations to take disciplinar) action against the delinquent members including expulsion suspension or an) penalty of like nature not involving the levy of monetary penalty. SEBI is alsc endowed with the power to withdraw the recognition of self regulator organizations in the interest of trade and the public. This means that sel regulatory organizations function under board supervision[27] and divide th< burden on the SEBI. Although regulation 14 provides a lose framework as t< the possible role of self regulatory organizations, it still retains discretionar power of the board to alter or expand the same through directions unde regulation 14(1). If corporate governance is included in their scope o functions these organizations can prove effective to ensure compliance wit self regulatory codes of conduct by monitoring companies within an industry Currently self regulatory organizations are voluntarily formed and ai subsequently recognized by the SEBI. This norm needs to be altered t compulsory formation of self regulatory organizations industry wise to gi\ due effect to the code for corporate conduct which can be done by a mei SEBI notification and requires no legislative amendment. SROs can be mac better functional and efficient under the regime of *directed self regulation i* proposed above. It would eliminate the drawback of unenforceability ar voluntary formation of SROs by giving them wider powers includir enforceability under Regulation 14 (1).

Regulation 14 of the SEBI (Self Regulatory Organization Regulations), 2004.

The board of self regulatory organizations would comprise of SEBI nominees, brokers and independent members. They would function to conduct random checks on about 10-15 (number to be fixed as per industry size) companies in their industry area to ensure compliance of the company with its adopted code of conduct. A report on their conducted investigation would be then submitted to the SEBI who can investigate further in case needed under -its investigatory powers enshrined in the SEBI Act, 1992. The nature of Self regulatory organizations will thus be administrative and regulatory only. The proposition is that they will posses no adjudicatory powers as delegation of adjudicatory powers by SEBI is *ultra vires* its powers.

IV. Conclusion

The recurrent securities market scams and corporate frauds across the globe have time and again questioned the prevailing corporate governance standards, if not the efficiency of the market regulator. Indeed, the practical possibility of such incidences cannot be completely eliminated by any system of governance as such idealism does not exist. However, the extent of the consequences, the impact on economy and markets and the gravity of non-compliance compel us to seek better and more effective means of enforcing corporate governance norms.

The proposed model may face certain operational limitations which can be overcome by making minor modifications and adaptations. It is merely a step ahead of the long prescribed remedy in the form of self regulation by several committees; in as much as it aims to broadly lay down an effective enforcement mechanism for self governance. Without any direction as to the enforcement of such a system, self regulation cannot gain popularity and wider following.

As elaborated above, self regulation can provide a path breaking success in the enforceability of corporate governance and achieve far greater compliance, if not absolute compliance. The proposed model of *directed self regulation* as opposed to the De regulation/self regulation models in place, is suited well for the present economic and market scenario as it charts out well defined roles at different levels for corporate governance, namely - the individual company level, the industry level and the maiket regulator's level. The role of the company is to provide for applicability of self adopted governance rules. The role of the industry self regulator is to set standards for the industry participants for self governance. Finally, SEBI's role is given as the supervisor and enforcer of these regulations.

Shareholder Activism: A Necessity to prevent Corporate Frauds

*Kanika Sanwal & Shreevidhya K.R**

Public Companies in India are largely family-run and promoter dominated entailing huge investments from shareholders. However, this corporate structure provides avenues to promoters for undue enrichment and the shareholders who have invested in such companies do not actively participate in the operations of the company neglecting the need for transparency. Shareholder activism in India is largely absent in comparison to other western countries especially USA.

The recent Satyam fiasco has turned out to be the biggest fraud by an Indian Corporate and has been popularly referred to as the Indian Enron. The episode marked the black letter day for the history of Indian Corporate System. Despite Satyam Promoters owning only 8.61 % of the Stock and pledging most of it to raise money they were able to unilaterally take decisions with respect to acquisition of Maytas and engage in enormous financial fraud to the tune of Rs. 7500 crores without the approval or knowledge of the other shareholders.

Even with the increase in investments by foreign and Indian institutions and ordinary shareholders, Indian companies by and large continue to be run at the whims and fancies of the promoter group. Though shareholder activism is negligible in India, provisions of various statutes provide various recourses to shareholders to uphold their rights. This article aims to detail out the remedies available to the Shareholders in cases of fraud committed by the companies and suggests options to increase shareholder democracy in the functioning of the Companies. Further, we propose to examine the regulatory framework in India which makes committing fraud so easy and hard to detect, and would offer recommendations to close the loopholes and better the corporate governance in our country.

' Students, 5 th Year, National Law University, Jodhpur

CONTENTS

I. Shareholders' Rights: Legal Provisions

A. The Companies Act, 1956

Right to Hold Extra Ordinary General Meeting (EGM) -To call an EGM, shareholders have to hold a minimum of one tenth of the paid up capital of the company. The shareholders have to specify the agenda for which they consider the meeting to be necessary. In the landmark case of *LIC v Escorts*[1] the Supreme Court held that even institutional shareholders are statutorily entitled to call an EGM. No reasons are required to be given for requisition of an EGM and nor can the reasons be subject to judicial review. Once a valid requisition has been submitted, the Company should call a Board Meeting and the Board of Directors are obligated to call the EGM , even if some of the requisitionists have withdrawn their consent or ceased to be members.[3]

Right against Oppression - Under Section 397, any member of a Company can file an application to the Company Law Board[4] stating that there has been a continuous act of oppression on part of the majority shareholders upto the date of the petition.[5] According to Section 399, the application can only be made if a minimum of one hundred members or one

[1] (1986) 59 Com Cases 548 (SC)
[2] *V.G Balasundaram* v. *New Theatre Carnatic Talkies Pvt. Ltd.*, (1993) 77 Com Cases 324 (Mad.)
[3] Justice Y.V. Chandrachud, Dr. S.M. Dugar (eds.), A Ramaiya, *Guide to Companies Act*, (Wadhwa and Company, Nagpur, 16th edn., Part I, 2004) p. 1644
[4] It has been substituted by National Company Law Tribunal by Companies (Second Amendment) Act, 2002 but has not yet come into effect
[5] *Shanti Prasad* v. *Kalinga Tubes*, (1965) 35 Com Cases 351(SC)

•tenth of .the total members or members having not less than 10 percent of the 'total issued capital support it. For relief under Section 397, "a *conduct which lacks in probity, conduct which is unfair to and which causes prejudice to the petitioner in the exercise of his legal and proprietary rights as a shareholder"* must be shown to exist.[6] The scope of Section 397 is not necessarily limited to the strict legal rights but may extend to wider equitable considerations such as any legitimate expectations of a member.

Right against Mismanagement - Section 398 confers a right to

o

members of a company to apply to the Company Law Board in case oi mismanagement in the affairs of the company. An application under this section can be made if it is shown that the affairs of the company are being conducted in a manner prejudicial to the interests of the company. The application should confirm to the requirements of Section 399 of the Companies Act, 1956.Mismanagement under Section 398 does not onl> include financial mismanagement[10] but also embraces absence of records anc losses", sale of assets at lower price[12], violation of statutory provisions[1] anc Memorandum of Association[14]. While exercising jurisdiction under Sectioi 398 the court can pass any order and lay down the procedure fo

[6] *Needle lndustries(India) Ltd.* v. *Needle Industries Newey (India) Holding Ltd.,* (1981) 5 Com Cases 743 (SC)

[7] Justice Y.V. Chandrachud, Dr. S.M. Dugar (eds.), A Ramaiya , *Guide to Companies Act* (Wadhwa and Company, Nagpur, 16th edn., Part I, 2004) p. 3359

[8] It has been substituted by National Company Law Tribunal by Companies (Secon Amendment) Act, 2002 but has not yet come into effect

[9] *Richardson & Cruddas Ltd.* v. *Haridas Mundra,* (1959) 29 Com Cases 549

[10] *Re Macro(Ipswich) Ltd.* (1994) BCLC 354, 404 (Ch.D)

[1] *Chander Krishan Gupta* v. *Panna Lai Girdhari Lai Pvt. Ltd.,* (1984) 55 Com Cases 70 (Del)

[12] *Moorthy* v. *Drivers and Conductors Bus Service Pvt. Ltd.,* (1991) 71 Com Cases 136 (Mac DB)

[13] *Akbarali A. Kalvert* v. *Konkan Chemicals Pvt. Ltd.,* (1987) 88 Com Cases 245 (CLB)

[14] *S.M Ramakhshna Rao* v. *Banglore Race Club Limited,* (1970) 40 Com Cases 674 (Mysore

implementing its order.[15] Further, under Section 402, the Company Law Board has the power to replace *en bloc* all the directors as a relief against mismanagement.[16]

Removal Of A Director By Shareholder - Section 284 recognizes the inherent right of shareholders to remove the directors appointed by them. Section 284 provides the procedure to be followed for the removal of directors before the expiry of his term of office. The director can be removed by an ordinary resolution of which a special notice has been given. It is not even necessary that there should be proof of mismanagement, breach of trust, misfeasance or other misconduct on the part of the directors. Where the shareholders feel the policies pursued by the directors or any one of them are not to their liking, the shareholders can take the recourse of Section 284.

Relief for Misstatement In Prospectus - If any person (like the directors, promoters) provides misleading information or fails to incorporate the complete details in the prospectus, he is criminally liable and punishable with fine which may extend to fifty thousand rupees. The allottee can claim relief for misrepresentation in prospectus if he can prove[17]:

1. That the misrepresentation was one of fact
2. That the allottee acted upon the misrepresentation

[15] *Gopal Shamsher Jang Bahadur Rana* v. *Jagdish Chandra Chowdhury,* 1981 Tax LR NOC 151 (Cal)

[16] *Shoes Specialties Limited* v. *Standard Distilleries and Breweries Private Limited, (1997)* 1 Comp LJ 243

[17] Justice Y.V. Chandrachud, Dr. S.M. Dugar (eds.), A Ramaiya ,*Guide to Companies Act,* (Wadhwa and Company, Nagpur, 16th edn., Part I, 2004) p. 651

3. That the misrepresentation was material

However, a director or other person responsible for the prospectus shall not incur any liability if he proves that he had no knowledge thereof; or that the non-compliance or contravention arose from an honest mistake of fact on his part; or the non-compliance or contravention was in respect of matters[1Q] which, in the opinion of the Court dealing with the case were immaterial. *SEBI is also empowered to* punish the company for the contravention of section 56(3) of the Act.[19] Shareholders are eligible to file complaints against all offences under the Companies Act, 1956 as per Section 621 to any court not inferior to that of Presidency Magistrate or Magistrate of the First Class.[20] Apart from going to Court, Shareholders also have the alternative options of approaching the Registrar of Companies or SEBI or Stock Exchanges or Ministry of Corporate Affairs.

Penalty imposed for False Statements - As per Section 628, a shareholder can file a complaint to the Criminal Court (where the Company's registered office is situated[21]), if any person makes a false statement through any return, report, certificate, balance sheet, prospectus, statement or other documents or omits any material particular in any document required for the purposes of the Companies Act, he shall be punishable with imprisonment for 2 years and fine. The Satyam scam brought into light the crucial role played by the auditors in financial frauds. An auditor has a fiduciary relationship with

8 Section 56(4) of the Companies Act, 1956
19 *[Notification No. 727(E) dated 18th September, 2000].*
20 Section 622 of the Companies Act, 1956
21 *H. V. Jayaram* v. *ICICI Ltd.*, (2000) 99 Com Cases 341 (SC)

the shareholders[22] and in auditing the accounts maintained by the directors, the auditor acts in the interests of the shareholders who are in a position of beneficiaries.[23] For any mis-statement, non disclosure he can held guilty of professional misconduct as per Section 22 of the Chartered Accountants Act, 1949.

Derivative Action -The Board of Directors are in the position of trustees and owe a fiduciary obligation to the shareholders. If directors fail to live up to their duties, or involve themselves in ultra vire and illegal acts , Courts can authorize a shareholder or a group of shareholders under a *derived authority* to sue on behalf of the company for asserting the company's rights. The shareholders can seek any relief beneficial to the company.

Application To Company Law Board -As per Section 235 of the Companies Act, 1956 on an application from not less than two hundred members or from members holding not less than one tenth of the voting power to the Company Law Board; the Board would declare that the company be investigated. After the declaration by the Board or Registrar's report (under Section 234(6)] the Central government is empowered to appoint an investigator to look into the affairs of the company. Further, under section 635 of the Act, the Central Government may investigate the affairs of the Company including through the Serious Frauds Investigation Office. The Ministry of Corporate Affairs also accepts complaints from investors and refers complaints to the Serious Fraud Investigation Office.

Institute of Chartered Accountants v. *P.K Mukherjee,* AIR 1968 SC 1104
CITv. Dandekar [1952] 22 ITR 235 (Mad.)
Satyacharan Lai v. *Rameshwar Prasad Bajoria,* (1950) 20 Com Cases 39.

B. Application to SEBI

Shareholders can complain to SEBI's office of Investor Assistance and Education for fraudulent activities and any violations of the SEBI Regulations by the company or its officers. Moreover, SEBI (Under Section 11 of SEBI Act, 1992) can *suo moto* investigate the non compliance by the listed companies and can impose penalties on the defaulters. Section 621 of the Companies Act, 1956 empowers SEBI to file complaints for otfences relating to issue and transfer of securities and non-payment of dividend.

Breach Of Clause 49 Of The Listing Agreement - Working towards the best interests of shareholders through adequate and timely disclosures of financial situation, performance, ownership and governance of the company forms the very basis of corporate governance.[25] Clause 49 of the Listing agreement secures healthy corporate governance by companies. Clause 49 specifies the requirement as to the independence of directors . Such directors have a responsibility with respect to any of the decisions to be taken by the Board with respect to the Company matters. It is questionable whether today Indian Corporate Houses having family run businesses actually have independent directors in the true sense of the word. The role of independent directors and their scope of responsibilities have come under the scanner following the Satyam episode. One needs to reflect and deliberate on criterion for the qualification of the Independent Directors. Is it just independence that is the qualification or is independence and the capacity to understand the business that is required, when a company appoints independent directors on

Organization for Economic Co-operation and Development, (April 1999)
Clause 49 (I A)(i) of the Listing Agreement.

[97]

the Board?" Shareholders in such cases can exercise their rights by voting to remove the Directors from their office as per the Company Law provisions(Section 284 of the Companies Act, 1956) or can complain to SEBI for non compliance by the company with Clause 49 of the Listing Agreement.

Related Party Transaction - Related party transaction refers to a transfer of resources or obligations between related parties regardless of whether or not a price is charged. Such transactions require a high degree of disclosures, because conflict of interest can affect the ability of the decision maker to function objectively and effectively. Today principles of corporate governance are generally avoided by following them on paper but not adhering to them in the true spirit. Undue Enrichment of the promoters, directors and other officials by involvement in related party transactions smacks of abuse of the position of authority and amounts to breach of the principles of corporate governance. Shareholders can actively pursue deals undertaken by the Company and can revoke such deals to protect the best interests of the company

"interview with Rajeev Chandrashekhar , Nasscom FICCI call for revamp of corporate governance norms, MoneyControl, January 7, 2009, http://www.moneycontrol.com/india/news/business/nasscom-ficci-call-for-revampcorp-governance-norms-/375191, < visited on 10th March,2009>

Related party - parties are considered to be related if at anytime during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.
Accounting Standard 18, http://www.mca.gov.in/MinistryWebsite/dca/notification/pdf/ AS_18.pdf, <Last visited on 10th March,2009>

[29] Accounting Standard 18, http://www.mca.gov.in/MinistryWebsite/dca/notification/ pdf/AS J 8.pdf., Last visited on 9* March,2009 [0] Clause 49 (IV A) of The Listing Agreement

Insider Trading And Fraudulent & Unfair Trade Practices - Price manipulation refers to artificially raising or depressing the prices of securities and thereby inducing the sale or purchase of securities by other investors. SEBI, through SEBI (Prohibition of Insider Trading) Regulations, 2002 and SEBI (Fraudulent and Unfair Trade Practices relating to Securities Market) Regulation, 2003 has targeted companies who engage in price manipulation to increase the market price of their shares. Shareholders in cases, where the acts of the companies in a premeditated manner creates a false or misleading appearance of trading on the securities market, when the company issues misleading advertisements or news that influence the decision of investors or induce the sale or purchase of securities etc.; then in such cases shareholders have the right to approach SEBI and get the company prosecuted for its deceptive activities. Contraventions by companies amounting to fraudulent and unfair trade practices attracts penalties extending from cancellation/suspension of registration of intermediary, impounding and retaining the proceeds or securities, suspending trading in the Company's shares etc. SEBI is further empowered to restrain persons from accessing the securities market and prohibit any person to deal in securities; suspend any office bearer of any stock exchange or self-regulatory organization from holding such position; and also to impound and retain the proceeds or securities in respect of any transaction which violates regulations.

[31] Regulation 4(b) of the SEBI (Fraudulent and Unfair Trade Practices relating to Securities Market) Regulation,2003

C. Application to Stock Exchanges

A Public Company whose securities are listed at a Stock Exchange has to previously enter into an agreement with the Stock Exchange called the Listing Agreement, under which they are required to make certain disclosures and perform certain acts, failing which the company may face some disciplinary action, including suspension/delisting of securities. The Listing Department of the Stock Exchange monitors the compliance of the companies with the provisions of the Listing Agreement, especially with regard to submission of periodical financial results, requirement of minimum number of shareholders etc. and takes action in case of any default. Shareholders in case of any objections against the company, non compliance by the company, have the right to approach the Investor Grievance Cell of the Stock Exchanges (BSE, NSE). Stock exchanges have the power to take *suo moto* cognizance of any non compliance of their norms by a Listed Company and take appropriate steps against the company.

D. Provisions under the Indian Penal Code

Criminal Breach Of Trust - Section 405 deals with criminal breach of trust. It is the dishonest misappropriation of another's property or conversion of the property; to one's own use by a person to whom it has been entrusted, or into whose hands it has lawfully come. Directors are in a

Section 405 of the Indian Penal Code, 1860 : Whoever, being in any manner entrusted with property, or with any dominion over property, dishonestly misappropriates or converts to his own use that property, or dishonestly uses or disposes of that property in violation of any direction of law prescribing the mode in which such trust is to be discharged, or of any legal contract, express or implied, which he has made touching the discharge of such trust, or wilfully suffers any other person so to do, commits 'criminal breach of trust' fiduciary relationship with the shareholders. Any dealing with the company's property in a manner prejudicial to the interests of the shareholders, will amount to dishonest use of that property. A Director of a company is not only an agent but is also in the position of a trustee and being a trustee of the assets, which has come into his hand, he has dominion and control over the property of the company.[33] A director must use the company's assets entrusted to him for the company's purpose and interest. For any dishonest misappropriation of the company's property, regardless of whether or not he has personally benefited from it, he can be prosecuted by the shareholders under Section 409 of IPC. The Directors can be imprisoned for a term extending to three years with or without fine.

Cheating - Shareholders can bring the Directors to Court for cheating under Section 415 and 418. Cheating in relation to directors includes within its purview dishonest concealment of facts, or for intentional inducement to do something which a shareholder wouldn't have done in other circumstances (For Example the Directors of the company cooked up the balance sheet which they knew to be materially false and like to mislead the public as to the condition of the company and which induces an investor to buy the shares of the company[34]) The Directors can be imprisoned for a term extending to three years with or without fine.

Criminal Conspiracy - Directors can also be held criminally liable on the charge of criminal conspiracy on a complaint by the shareholders. The ingredients of Section 120A are that there must exist an agreement between

[33] *Dale & Carrington P. Ltd.* v. *P.K. Prathapan* (2004) 4 Comp. LJ 1 (SC)
[34] Ratanlal and Dhirajlal, *The Indian Penal Code,* (Wadhwa and Company, Nagpur, 31st Edition, 2006) p. 2255

persons alleged of conspiring and the agreement should be for doing an illegal act or for doing by illegal means an act which may not be illegal. Direct or circumstantial evidence to show that there was an agreement between two or more persons is essential. As Criminal conspiracy is considered an extremely serious offence it is punishable with death, imprisonment for life or rigorous imprisonment for two years or more.

Falsification of Accounts(Section 477A of the Indian Penal Code, 1860):-Investors can bring to book the Officers or clerks who engage in destruction, alteration, mutilation falsification of an book, electronic record, paper, writing, security, accounts with an intention to defraud under Section 477-A. As per this section, it is mandatory that the person charged has undertaken to perform and performs the duties of clerk, officer or servant regardless of whether he is a servant or clerk or officer. Deprivation of property is not an essential, but mere falsification with intent to expose some person to actual or risk of probable injury is sufficient to render the officer or clerk or servant criminally liable.[35] Under S. 477A of the IPC, a person may be imprisoned for maximum of 7 years' and/ or be asked to pay fine and is non- bailable.

E. Action by Overseas Shareholders

Class Action by the ADR Holders -A class action lawsuit is filed on behalf of a group of people who have been in some way injured by the actions of a company. Class action treatment is superior to the alternatives, if any, for

R.Madhavan v. *State of Kerala* 1973 CrLJ 1534 the fair and efficient adjudication of the controversy alleged herein. Such treatment permits a large number of similarly situated persons to prosecute their common claims in a single forum simultaneously, efficiently, and without the duplication of effort and expense that numerous individual actions would engender. For instance, following the confession by the Satyam founder and chairman B Ramalinga Raju's to a Rs 7,000 crore fraud in the company, the ADR holders reacted strongly to the entire episode; and filed two class action suits in United States District Courts against Satyam as per the provisions of the Securities Exchange Act, 1934. ADR/GDR holders can also bring criminal proceedings and civil shareholder lawsuits in their respective countries.

II. Suggestions

Regardless, of the quality of our laws, the real test of the laws lies in its enforceability. Reduction in time, red tape-ism in adjudicating the case and the promptness in execution of the award would go a long way in boosting investor confidence to make use of the various avenues available. The following suggestions may be incorporated in so as to ensure that the system is strengthened :-

1. As shares and securities are by law defined as "goods" under the Consumer Protection Act, 1986, legal redressal of investor grievances should be encouraged to approach the Consumer courts under the Consumer Protection Act. To enable shareholders to take full advantage of the provisions of the Consumer Protection Act, the extent to which the jurisdiction of the Consumer Courts will apply would have to be specified

with regard to the nature of the investment and the benefits accruing to the investors.

2. Institutional shareholders should not be passive onlookers but take on an active role. If they perform their role taking full advantage of all the legal options available to them, then they would keep the management/BOD on their toes.
3. Investor Education is indispensable. Only when the vast majority of investors are made financially literate, and aware of their rights would a strong shareholder gatekeeper culture emerge. SEBI should focus more resources on investor education and awareness building. It would have far •reaching effects on the corporate culture of our country.
4. Class action suits in the form of derivative suits should be actively encouraged.
5. Defective disclosures by the management should be as much a cause of action by the shareholders as a breach of fiduciary duties.
6. Third party suits on behalf of the shareholders, such as by consumer organizations should be encouraged, and traditional hindrances to *locus standi* should not be allowed to obstruct the suit from being adjudicated.
7. Investor Compensation Fund (ICF): As has been proposed in the USA, a department can be administered by SEBI to undertake investor compensation in cases of frauds. The funding will come from assessments on equity securities transactions. Every time a share is sold in the secondary market, the selling shareholder will pay a fee, set as a percentage of the value of the sale transaction (the premium"), that will be placed into a fund to be used for investor restitution in the event of losses

[36] http://www.mca.gov.in/MinistryWebsite/dca/latestnews/reportonexpertcommitte/chapter7 .html last visited on 10th March 2009

from securities fraud. No selling shareholders will receive a refund of any amounts deposited into ICF, even if no shareholder of a particular company ever makes a claim for recovery. Participation in the ICF scheme will be mandatory for public companies and investors. When a shareholder files charges with the ICF Division, the ICF Division will conduct an investigation to determine whether there is reasonable cause to believe a securities violation has occurred.

III. Conclusion

Shareholder democracy can act as a check against the excesses of the Company and active Investors can aid in the development of good corporate governance practices. Shareholders, can demand that companies follow transparent practices and disclosure of all the requisite information would become the norm rather than an elusive ideal.

Since, the financial security of so many shareholders has become inextricably tied to the Nation's capital markets, greater vigilance in the detection of frauds by companies is indispensable. Shareholders should realize their legal rights and recourses available to them in cases of corporate excesses. They should not hesitate to exercise their rights in cases of manipulation, malpractices, fraud and unfair trade practices which erode investor confidence and jeopardize ;he interest of hapless investors.

Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. Corp. L. 223, Fall 2007

Corporate Social Responsibility & Corporate Governance

*Udayaditya Banerjee**

The sixties and early seventies were turbulent times. Opposition to the Vietnam War, the environmental and civil rights movements, and radicalism generally roiled the corporate world, as much as the world at large. These disparate strands coalesced into the "corporate social responsibility movement," culminating in strident advocacy of federal chartering of large corporations, mandatory public interest directors, and required social accounting and disclosure. A principal feature of that movement is that, unlike in the early 1970s, the social responsibility is seen as converging with, rather than diverging from, broader trends in corporate governance, most specifically the "good governance" movement, which has been underfoot in many countries around the globe for well over a decade now.

In the 1990s and the twenty-first century, the pendulum has centred. The generally accepted governance model envisions a board of directors made up by a super majority of truly independent directors. Independent directors supply the monitoring and fill the void dispersed shareholdings produce and the separation of ownership from control highlights. Instead of attempting to manage the corporation's business and affairs, in the "good governance" movement, directors take on a more focused mission. With its independence preserved by a board nominating committee- itself comprised of independent directors—and the integrity of information upon which to base evaluations aided by an audit committee, the board's role is to hire, monitor, and, if necessary, replace the senior executive officers, most particularly the chief executive officer.

With this article, the author shall attempt to understand the scope of corporate social responsibility and its relationship with corporate governance. The balancing act carried out by corporation between profit motives and at the same time maintaining the ethical/moral responsibility that they owe towards the society at large.

' Student, 5' Year, National Law University, Jodhpur

120,000 people continue to suffer from severe health ailments related to fJ accident and contamination[1].

In 2001, the US-based gigantic Dow Chemical purchased Uni< Carbide, thereby acquiring its assets and liabilities. However, it has be steadfastly refusing to clean up the site, provide safe drinking water compensate the victims, or even disclose the composition of the gas le; Dow, like UCIL earlier, claims that it has no liability of the past. The D< Chemical Company, with an annual sale of $28 billion, says it is "commit to the principles of Sustainable Development, and its approximately 50,C employees seek to balance economic, environmental and soc responsibilities."

B. Has anything changed?

What in effect has changed during the past two decades in India in time span between the above examples? Undoubtedly, on the one hand, business operating environment has turned from one, which was ope hostile (The Coca Cola Company was asked to leave India in 1977) to be very warm and welcoming in India's new era of economic liberaliza (India is now marketed as new global business destination).

This has not reflected in any new responsible behaviour on the sid the corporates themselves. In fact, while some cases come to light, ot

' *http://wwwMu.mtu.edu/hu_dept/tcCtymtu/papers/bhopal.htm* <last visited 15/03/2009> [2] US$ 3.4 billion Foreign Direct Investment (FDI) into India in 2001- 2002, compared to USD 43 billion in China. India policy is to pursue higher FDls. *http://www.atimes.com/atimes/South_Asia/DI07Djf07.html* <last visited 15/03/2009>

remain hidden. For example, multinational companies exploring new markets in India have been known to resist more stringent environmental legislation in India, which may be at par with those in developed countries[3]. Many international brands, marketing new materials such as plastics, food packaging or electronics do not bring along systems of waste minimization or management, which they readily incorporate into their western operations. Corporate Social Responsibility then does not seem to be a globally practiced work ethics.

On the other hand, during the same period, "Responsible Care," "Corporate Social Responsibility (CSR)" and the UN based "Global Compact" were new terms to have found increasing international legitimacy as today's way of doing business. But are they real? As corporates become more global and enter newer developing country markets, such as in India and China, these terms are widely used on websites, in corporate literature and in presentations, evidently to convince people that things have changed and that a new ethical global business practice is underway. However, the nature of engagement on the ground leaves a lot to be desired.

C. India and CSR

In India, the market is the new 'mantra.' Globalization has brought in new players and alluring products into markets. The growing middle class, which has been bereft, of 'goods' in the past, is too happy consuming, to want to pay heed to what may lie underneath. American style, glass lined shopping

[3] Various environmental norms in India are much more lax than EU norms for example and resisted by multinationals.

malls teem with the newly rich. Plastic money has made hitherto inaccessible goods merely a signature away. It is a new ethos, expectant and eager, which draws in glitzy brands supported by nubile advertising. The dismal human condition of the rest of the country does not exist here, and the fact that over 25 % of the country does not have even a meal a day is mere statistics.[4] It is an engagement, which for many is an uncomfortable one, and a willingness to believe in corporate literature an easy 'out' of any possible guilt. In such a context the picking seems to be easy for businesses with the 'system' available to be beaten for profit. Terms like *'ethical behaviour'*[1] can put an uncomfortable hurdle in that path and for powerful corporate bending rules, is not too difficult. Corporate philanthropy helps as well. NGOs are funded to carry out 'community development' work, and these too are advertised as part of the branding process[5]. Cynically, such donations also obtain local tax rebates. But even though some people may benefit from such charity, it does not translate into changing the way business itself is done. A few pertinent questions that can be raised at this stage are:

- Can Corporate Social Responsibility truly be a reality in such a context?
- Does it need other legal and institutional pushes which empower the citizenry to function adequately?

[4] India is home to the largest number of hungry people in the world, According to the United Nations Development
Program's "Human Development Report," this exceeds 233 million hungry people, c.f. *http://www.foodrelief.org/articles/22/1/lndia-has-largest-number-of-hungry-people-UN/Pagel.html* <last visited on 15/03/2009>

[5] Unilever website for example states "Community involvement is one element of our corporate social responsibility. Around the world our brands and companies engage with a wide variety of social and environmental causes to help people, their communities and the environment." c.f. *http://www.article 13. com/A13 ContentList.asplstrAction=GetPublication&PNID=1359* <last visited on 15/03/2009>

Such provisions can include effective liability laws, information disclosure requirements, corporate accountability and an impartial implementation of various citizens' rights through various bodies. Take the case of producer responsibility for waste management. Many countries in Europe, including Switzerland, Sweden, Germany etc, by law need companies to collect used cars, television sets, computers, and batteries and to dispose them off. However, these 'responsible' models work in the given legal and social milieu. The same companies do not show such 'enlightened' behaviour in India, and in fact often resist the setting up of such systems through their immense lobbying powers with governments. It would be futile to expect CSR to work in such an environment. It can be argued that without such enabling conditions in a society, CSR cannot effectively work. It would need a functioning democracy that delivers not only in its intent but also in its institutions. When the balance of power in areas of civil liberties, environmental and social rights between industry, the citizens, and the state is equal then CSR could guide the larger role business has to play. Under such political conditions CSR, even when voluntary, puts a high degree of accountability onto the corporate entity. Shareholders would then accept that business goes beyond profits and dividends, into the manner in which these have been achieved.[6]

In another realm, where institutions meant to protect rights of society are not firmly in place and the power to influence processes is not vested enough in the citizenry, CSR could become out of place and misleading. No

[6] Corporate Social Responsibility: a critical perspective from India, by Ravi Agarwal c.f. *http://www.toxicslink.org/qdocs/Corporate_Social_ResponsibilityjnJndia.pdf* <last visited on 15/03/2009>

doubt India is a democracy, one that is very successful at ensuring a peaceful transference of power through an electoral system every five years.

Yet, the country faces gross social inequities of poverty and a new affluence for a few. Human, consumer and environmental rights are contested terrains, and corporate scandals are commonplace. Many environmental and social legislations have been enacted under its strongly democratic Constitution. However, implementation is dismal and reflects the fact that Institutions responsible for this are weak and unaccountable to public pressure. In some areas, especially relating to marginalized sections like workers, there is also an inadequate legal focus.

For example, there is no comprehensive Occupational Safety and Health Act, nor are Information Right laws in place. Though India is party to several international environmental and labour conventions, many such treaties including International Labour Organization (ILO) and United Nations Environmental Program (UNEP) have not been ratified[7]. Corruption in high circles is regularly reported,[8] but convictions are almost non-existent. In such a scenario, CSR then becomes a mere 'web site' declaration, with no pressure to deliver on the ground.

[7] The UNEP POPs as well as PIC Conventions, the ILO' Freedom of Association and Protection of Right to Organised Convention (No.87), Right to Organise and Collective Bargaining Convention (No.98), Minimum Age Convention (No. 13 8), Worst forms of Child Labour Convention (No. 182)

[8] In a scandal in October 2003, a Cabinet Minister was caught on videotape accepting bribe from a representative of an Australian mining company. He had to resign. The case is under investigation, c.f. *http://www.globalintegrity.org/reports/2006/india/timeline.cfm* <last visited 15/03/2009>

II. What is Corporate Social Responsibility?

In their key *Communication of 2002,* the *European Commission* presented CSR as - *"a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis. "* As with all other efforts to spell out the notion (at the EU level, as well as in the context of the activities of the United Nations, the OECD, and various other supranational bodies), particular note should be taken of the word *"voluntary."* Thus, actions within the framework of CSR are seen as complementary to, rather than as a part of, normative regulatory processes. For many commentators, indeed, this has developed into yet another laboratory in which to test propositions about the efficacy and desirability of so-called "soft law" forms of regulation, in preference to more traditional "hard law" regulatory approaches.

This has immediately given rise to controversy over the impact of any such actions—with more pessimistic observers commenting on the absence of sanctions to underpin any voluntary undertakings, while others prefer to stress the advantages of voluntary commitments in terms of flexibility, nuanced self-regulation, and what are presented as "mature" corporate governance frameworks.[10]

'Communication from the Commission concerning Corporate Social Responsibility: A business contribution to Sustainable Development , COM(2002) 347 final c.f. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2002:0347:FIN:EN:pdf <last visited 15/03/2009>

[10] For *e.g.*, the concerns expressed by the European Trade Union Confederation (ETUC), Press Release, ETUC Office of Press and Communications, Corporate Social Responsibility and European Trade Unions: Danger of a Rift (Mar. 14, 2006), c.f. *http://www.etuc.org/2190*. <last visited 15/03/2009>

The European Council's ensuing *Resolution of the Employment and Social Policy Council on CSR,*[n] drew inspiration from the European Commission's earlier Communication, in which it was laid out what have come to be described as received "principles" of CSR— involving:

> *"recognition of the **voluntary nature** of CSR; a need for credibility and transparency of CSR practices; a focus on activities where Community involvement adds value; a balanced and broad approach to CSR, including economic, social and environmental issues as well as consumer interests; attention to the specific needs and characteristics ofSMEs; and support of, and compatibility with, existing internationally agreed instruments. . . .* "

Once again, the emphasis is upon the "voluntary nature" of any actions—this time taking into account any existing "internationally agreed instruments." In fairness, however, it should be noted that the European Council did go on to emphasize that: *"CSR is behaviour by business over and above legal requirements, which should continue to be properly enforced".*

Despite the wide spectrum of approaches to CSR, there is large consensus on its main features. Thus, it is suggested that:

- CSR is behaviour by businesses over and above legal requirements, voluntarily adopted because businesses deem it to be in their long-term interest;

[1]Council of the European Union, *Resolution of the Employment and Social Policy Council on CSR* c.f. *http://www.ialemiliaromagna.it/PUB/progetti/loderes/Documenti/DOCUMENTl/MatehaliUtili/EUjCouncil_Resolution_on_CSR.pdf* <last visited 15/03/2009>

- CSR is intrinsically linked to the concept of sustainable development: businesses need to integrate the economic, social, and environmental impact in their operations; and,
- CSR is not an optional "add-on" to business core activities—but about the way in which businesses are managed.

Not dissimilar values can be seen elsewhere, as, for example, in the context of the 1999 *OECD Principles of Corporate Governance,* where it is observed that:

> *"Corporate governance relates to the internal means by which corporations are operated and controlled. While governments play a central role in shaping the legal, institutional and regulatory climate within which individual corporate governance systems are developed, the main responsibility lies with the private sector. A good corporate governance regime helps to assure that corporations use their capital efficiently. Good corporate governance helps, too, to ensure that corporations take into "*

Further evidence of the interest aroused by concerns for improved corporate governance and the promotion of values that can be broadly considered under the rubric of CSR may be seen in the development of standards for benchmarking corporate behaviour in various dimensions. Particular mention should be made here of progress towards "SA 8000," and a

[12] OECD Principles of Corporate Governance *c.f.* http://www.bestpractices.cz/praktiky/ *ETIKA_V_PODNIKANI/p2003_oecd_principles_of_corporate_governace.pdf <last visited 15/03/2009>*

range of like developments, purporting to set measures against which corporate behaviour may be assessed in pseudo-empirical terms.[13]

The broader context for all of this has been a number of international texts and documents addressed to business, emanating both from global organizations, such as the United Nations or the OECD, and from regional bodies, such as the Council of Europe or the European Union.[14]

Even the Hon'ble Supreme Court has observed that the traditional view that a company is the property of the shareholders is an exploded myth.[15] According to the new socio-economic thinking, a company is a social institution having duties and responsibilities towards the community in which it functions. Obviously, the Hon'ble Supreme Court of India was referring to CSR, when it spoke of 'duties and responsibilities' towards the community. The generally accepted view is that if a company has the resources and has come a long way in its progress, it owes a debt to the society and the community in which it has progressed. Also, it is agreed that if a company has caused some loss to its surrounding areas, it is its obligation to make up for that loss, whether technical or environmental[16], as a part of its CSR.

[13] Social Accountability International's SA8000:2001 standard was developed in 1997 and has become the most widely recognized standard in this field.

[14] The ILO tripartite declaration of principles concerning Multinational Enterprises (MNEs) and Social Policy (1977, revised 2000); the OECD guidelines for MNEs (1976, revised 2000), at <u>*http://www*</u>. <u>*investment.gov*</u>. *eg/MOI_PORTAL/OtherSpeeches/OECDGuidelines.pdf* <last visited on 15/03/2009>

[15] *National Textile Worker's Union* v. *P.R. Ramakrishnan,* AIR 1983 SC 759

[16] The *Polluter Pays* principle as laid down by the Supreme Court in *UCC* v. *UOI,* AIR, 1992 SC 248 ; Indian Council of EnviroLegal Action v. UOI AIR, 1996 SC 1037

III. From Philanthropy to Stake Holder Participation: The New Paradigm of Corporate Social Responsibility

The conceptualization of corporate social responsibility up-till the 1990's was purely in terms of philanthropy or charity. Welfare programs or initiatives were introduced not as a duty or a responsibility but as a form of charity that was supposed to indicate the virtues of the company or the organization. Many industrial groups like the Tatas or Birlas setup charitable trusts that provided financial grants for various worthy causes. Although there were some cases where-the corporation took up a more active role like the establishment of the Birla Institute of Technology, Pillani by the Birlas or setting up of primary schools by several major industrial groups for their workers's children but even in these cases the approach was philanthropical.

However the post-liberalization phase has seen a fundamental shift from this philanthropy-based model of CSR to a stakeholder- participation based model. The change is evident in the statements about corporate social responsibility being made by India's leading industrial groups like the Tatas, "over *the years, the nature of the company's involvement with the community has undergone a change. It has moved away from charity and dependence to empowerment and partnership"* and the consistent transformation in their corporate social responsibility practices in the last decade. In the stakeholder model the community in which the corporation is present in is seen as a stakeholder in the company and therefore, the company has certain obligation and duties towards it like it has towards its other stakeholders (customers, employees, shareholders). It is a recognition of the fact that companies

[17] TATA Steel official website c.f. *www.tatasteel.com* <last visited on 15/03/2009>

perform in non-financial arenas such as human rights, business ethics, environmental policies, corporate contributions, community development, corporate governance, and workplace issues and company should be held accountable for its 'triple bottom-line' that includes social, environmental, and financial performance and not just the financial aspect.

IV. Public Sector Enterprises, Corporate Social Responsibility and Liberalization

In the article so far, the focus has been on the private sector and its greater societal obligations. India, also, has a large public sector with several huge corporations. Companies operating in various sectors like petroleum, heavy industries, aviation, mining, steel, equipment manufacturing and shipping. The Indian public sector has had a long tradition of corporate social responsibility and the initiatives of corporations like the Oil and Natural Gas Commission (ONGC), Steel Authority of India Ltd (SAIL) and Gas Authority of India Ltd. (GAIL) have been critical in the development of several backward regions of the country. Indian Airlines and Bharat Heavy Electronics have been widely acclaimed for their disaster management efforts.

The era of liberalization has led to the privatization of several public sector units and others being forced to make switch from being monopolies to being free market players with intense private competition. These dynamic process have raised several key questions related to the corporate social responsibility of the public sector:

Times Group official website c.f. *www.timesfoundation.org* *<last visited on 15/03/2009>*

- What should the social involvement levels of a company or corporation once it is privatized?
- Should public sector units continue to play the same social role as they did in the pre-independence era or is there a need to scale back their social responsibility initiatives?

These are questions that are central to the post-liberalization debate and need further analysis and research. Meanwhile, the opponents of privatization have used a 'corporate social responsibility' argument for their cause, they argue that considering the vital importance of the social role played by the public sector in India, there should not be any privatization of these vital industries. The P.S.U.s hold a very important position, especially with the certain social guarantee that it provides to its workers, contrary to what happens in the private sector. Hence, CSR should not be a ground to justify privatisation, as clearly PSU have a distinct social role of their own.

V. Conclusion

The new economic era in India i.e. the post-liberalization phase of the Indian economy was a catalyst for the radical transformation in the corporate social responsibility related practices in the country. The change was twofold: transformation of the conceptual understanding of corporate social responsibility and innovations at the implementation level. At the conceptual level, there was a fundamental transformation from the charity-oriented approach to the stakeholder-oriented approach where the target group was seen as stakeholder in the community whose well-being was integral to the long term success of the company. However, the real revolution occurred at the implementation stages where companies have started committing manpower, expertise in addition to financial resources in order to provide a host of services, programs and schemes that are flexible enough to accommodate the needs of the target community. The CSR initiatives have also seen greater people participation at all stages and tighter accountability standards. The issue of norms for CSR seems to have been adequately dealt with by industry practices like benchmarking, CSR ratings and certification by different agencies.

However, as of now, India is still not ready for a substantive law for the enforcement of CSR as it still needs to be flexible with its policy so as to balance the needs of a developing country- i.e. to attract foreign investors by providing a congenial environment to invest without having too many stringent law- along with its responsibility towards its own people. However, certain judicial pronouncements are a positive indication that the country is slowly getting ready for such a law. India is coming out of the traditional view of *'doing for the sake of if* and coming forward and realising their responsibilities. When the concept of CSR begins to be understood as a business oriented concept, without which the business would become difficult, it will be the time when India may be ready for statutory backing to the CSR.

Notwithstanding the above and any amount of sermonising on the CSR platform, ultimately we have to remember Milton Friedman's famous quote that *"the business of business is business"*. It reinforces the view that all CSR is driven by business interests and it is best left to the judgement of a corporate as to what makes good business.

Corporate Governance in Investment Management Companies

*Adhirath Singh, Krithika Ashok & Snigdhaneel Satpathy**

This Article aims at undertaking an in-depth study of the prevalent investment management regime. Companies which provide asset management services for third parties have to pursue good corporate governance as an integral part of their activities. This should be applicable in terms of responsible control and administration inside the company (Internal Corporate Governance) as well as the exercise of the voting rights or any additional shareholder rights by the companies as institutional investors in the interest of their clients (External Corporate Governance). The governance issues become all the more relevant in the light of the fact that they have an impact on the affairs of the companies in the fund portfolio. Thus, the companies should act independent of the interests of the owners, affiliated corporations and third parties, and instead act solely in the interest of the investors. At present the, the Asset Management Companies are governed by the SEBI guidelines and regulations. However, there is a void so far as the issues of corporate governance are concerned.

Therefore, in view of the corporate governance of the asset management companies, an attempt has been made to provide suggestions for the mitigation of potential conflict of interests, most notably where the fund's sponsor has business relationship or any other affiliations with the companies held in the fund's portfolio. The case of the HP-Compaq merger, aided by Deutsche Bank that held HP shares under their Asset Management Scheme, provides an insight into the very same problem. In light of the nature of the business conducted by the asset management companies, the viability of a more stringent disclosure mechanism would also be discussed. Furthermore, specific recommendations in the nature of a code for governance of the Asset Management Companies will be proposed.

'Students, 4th Year, National Law University, Jodhpur

CONTENTS

I. Introduction

In 1996, SEBI made registration of Asset Management Companies mandatory and imposed regulations.[1] In the past 12 years, while the regulator has experimented with minor changes in disclosure norms for listed companies, there has hardly been any revision for MFs despite the rapid growth of the industry making it grossly under-par. While the SEBI Regulations seem to be elaborate and extensive, there seem to be certain loopholes and ambiguities in the legal framework which leave scope for misuse. Thus, in the light of the primary concerns like conflict of interest and disclosure requirements, it is proposed that a holistic and comprehensive legal framework be adopted.

II. Conflicts of Interest

Legally, it is the directors of an investment company who are the guardians of the interests of both the company and its shareholders[2] putting them in a position to affect the reputation and the standing of any investment management company. However, conflicts are inherent in any relationship in which one party undertakes to act on behalf of another and are thus, inevitable in an investment management company. These conflicts reduce the ability of directors to fulfil their fiduciary duty, and therefore are of concern to the law.

[1] Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 (hereinafter referred to as the Regulations).
[2] *Smith* v. *Van Gorkom,* 488 A.2d 858, 872 (Del. 1985). c.f. Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or Why You Don't Want to Invite Homo Economicus to Join Your Board),* 28 Del. J. Corp. L. 1 (2003) (considering whether and why corporate directors are motivated to advance the interests of their companies).

It is undeniable that the investment funds have grown to such colossal proportions that it often plays an instrumental role in the shaping of the securities market and consequently a nation's economy. Further, the costs of the agency relationship in mutual funds is far more acute in comparison to an operating company because the fund investors have to be seen as both the customers and the shareholders of the mutual fund, placing a far greater duty on the Investment company. .

In such circumstances the potential weaknesses of investment fund accountability is a source of grave concern. These funds are registered as either a corporation or a trust, but differ from these entities because it is "organized and operated by people whose primary loyalty and pecuniary interest lies outside the enterprise." Such a fund has no employees of its own, but instead is organized and managed by a separate "sponsor," which, along with independent contractors, provides all services necessary for the fund's operation. The sponsor may be a bank, insurance firm, financial services firm, or securities broker. The sponsor employs and compensates any and all officers of the fund, including the board of directors.

This structure may result in significant conflicts of interest, especially where the fund's sponsor has business relationships with the companies held in the fund's portfolio. This was precisely the case which had happened in the corporate scandal of the Hewlett Packard merger with Compaq, aided by Deutsche Bank. In this case of the HP-Compaq merger, Deutsche Bank's investment banking division had a contract with HP for merger-related

[3] Div. of Investment Mgmt., U.S. SEC, Protecting Investors: A Half-Century of Investment Company Regulation 251 (1992).

services and was slated to earn an additional $1 million upon the merger's completion. At the same time, Deutsche Asset Management earned fees from investors for managing shares of HP stock in its mutual fund holdings, shares that had voting rights that Deutsche exercised in support of the merger.[4] Although the SEC's investigation did not establish that Deutsche Bank's relationship with HP affected its vote for the merger, and the Hewlett lawsuit was dismissed, the conflict of interest was identified.

Furthermore, these asset management companies are in itself a public company with its own shareholders, thus are bound by the fiduciary duties owed to those shareholders while at the same time the fiduciary duties owed to investors of the mutual funds which it advises.

There is another particular situation where an inherent conflict of interest arises in the investment management companies where a mutual fund's management of the retirement plan assets of a company whose stock is also held in that mutual fund. This was epitomised in the corporate scandal at Tyco. In this case Fidelity Investments voted against a shareholder proposal requesting that Tyco International maintain a majority of independent board members. At the time of the vote, Fidelity was managing Tyco's employment benefit plan and was earning millions of dollars in fees for this service.[5] In the aftermath of the corporate scandal at Tyco, Fidelity's vote may lend acceptance to the assertion that mutual funds have inherent conflicts of interests that must be mitigated through regulation or other mechanisms.

[4] Ariana Eunjung Cha, *Deutsche Bank Pays $750,000 in SEC Settlement,* Wash. Post, Aug. 20, 2003, at El.

[5] Matthew Benjamin, *Leaving the Little Guy Behind,* U.S. News & World Rep., Oct. 21, 2002, at 50.

Conflicts of interest can also arise in an investment company because of the relationship that normally exists between the company and its investment adviser. An investment company, which is usually created by its investment adviser, generates income for the adviser through the fees it pays the adviser, but all other things being equal, these fees reduce the profits earned by the company and hence by the company's shareholders. Shareholders will always seek to maximize their profits, a goal that requires investment companies to minimize costs. Accordingly, the fees paid by an investment company to its investment adviser promote a divergence between, on the one hand, the goals of the company and its investors and, on the other hand, the goals of the adviser.[6] Because most advisers control the investment companies they advise,[7] directors of an investment company can be aligned with the adviser and are subject to an obvious conflict of interest.

In light of the above, it is essential that the mitigation of this conflict of interest is done through the existing legal framework and develop better laws for corporate governance of the investment management companies. In India, the trustees are subject to disclosure of conflict of interest requirements in the similar manner as directors of a company. All the trustees must furnish to the board of trustees particulars of interest in any other company or institution or financial intermediaries. Each trustee is required to file the details of his transactions of dealing in securities with the mutual fund on a

[6] Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. IC-24083, 64 Fed. Reg. 59877 (Nov. 3, 1999) (this is an interpretation provided to the Investment Company Act of the United States which can be squarely applicable throughout India).
[7] Role of Independent Directors of Investment Companies, Investment Company Act Release No. IC-24082, 64 Fed. Reg. 59826, 59827 (Nov. 3, 1999).

quarterly basis with SEBI.[8] Nonetheless in India the conflict of interest is ill-defined and hence the certain suggestions have been incorporated in the later chapter. In the absence of a concrete and consolidated definitional framework as to the ambit and scope of the interest it becomes very difficult to pin-point the specific violations of the safeguards against the "conflict of interest"

A. Fiduciary Duty

The fiduciaries are granted broad discretion to make investments; however, they are subject to a standard of prudence that they are expected to exercise in making all investment decisions. This is known as the 'prudent person' investment standard[9] and in its modified form the 'prudent investor' standard[10]. The standard of prudent behaviour is used to examine the discharge of the fiduciary duty and serves as a guiding principle for the managers when there is a conflict of interest. A duty to divest within reasonable time, to diversify the investments and reduce risk also flows from this standard of prudence.

At common law, prudence is measured by the performance of each investment, although under the modern portfolio theory, it is to be measured by performance of the portfolio as a whole, rather than by each investment

Regulation 15(5) r.w. the Third Schedule of the Regulations; Aparna Viswanathan, *Indian Capital Markets: An Introduction To Regulation Of Mutual Funds*, (Corporate Law and Practice Course Handbook Series, PLI Order No. 11926 February-March, 2007).

[9] *Harvard College* v. *Amory*, 26 Mass. (9 Pick.) 446.

[10] "Prudent Investor" standard requires the actual expertise of a prudent person familiar with the investment matter under discussion, or the acquisition of such expertise through the advice of expert consultants, *Estate of Beach*, 542 P.2d 994, 1001 (Cal. 1975)

transaction. This theory appears more rational because the philosophy behind mutual funds is diversification and thus, it is only justified that an investment and its entailing risks be judged on a broader horizon. Under the latest school of thought however, prudence should not be measured by the performance rather by the process through which investment strategies and tactics are developed, adopted, implemented, and monitored. In other words, prudence ought to be demonstrated by the process through which risk is managed. [12]

Under the Indian legal framework, an overall reading of the Regulations imposes upon the trustees a fiduciary duty to act in the interest of the unit-holders. However, the fiduciary duties of the fund managers are vague, virtually unenforced fiduciary duties that mandate that fund directors and advisers act in the best interests of fund shareholders, and thus, almost meaningless. And thus, strengthening fiduciary duties has become one of the key elements for effective reform of the way investment companies are governed.

B. Need for Disclosure

Earlier, financial markets relied on competitive forces to determine 'optimal' levels of disclosure on the grounds that 'if disclosure is worthwhile

[1] See Richard H. Koppes and Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund through Relationship Investing,* 20 J. Corp. L. 413.
[12] Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* 35, at 84 (1986) *c.f.* Richard H. Koppes and Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund through Relationship Investing,* 20 J. Corp. L. 413.

to investors, the firm can profit by providing it.' However, soon it was recognised and accepted that disclosure is of utmost importance to protect the interests of the investors.

The fund managers owe a fiduciary duty towards the investors and, as a corollary to this it flows that the discharge of the fiduciary duty must be 'disclosed to the persons to whom the duty is owed'. The autonomy enjoyed by fund investors suggests that the regulatory response should focus on improving disclosure so that the investors may reach informed decisions. It also serves as an effective tool to examine the efficiency of the operations and helps in the timely detection of frauds.

However, such disclosure norms have also been opposed on the grounds that the trustees ought to be the appropriate overseers of the investment advisers' duties and mandating disclosure undermines their existing functions. Further, it is argued that such disclosure increases costs when infact, the individual investors are not interested in most of the information sought to be disclosed, rather only the performance results.[14] They invest in mutual funds because they lack the time, expertise or the willingness to research the portfolio investments and therefore, such additional disclosures would be futile.

[13] Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 213 (1991) c.f. H. Anne Nicholson, *Securities Law: Proxies pull Mutual Funds into the Sunlight: Mandatory Disclosure of Proxy Voting Records*, 57 Okla. L. Rev. 687.

[14] Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why not disclose?,* 23 Cardozo L. Rev. 1419.

However, the investors benefit in terms of the impact such disclosure requirements will have on the investment companies. Without a disclosure mandate an investment company has no incentive to act in the interests of the client because then it cannot be held accountable. Mandatory disclosure, on the other hand, will elicit the required fiduciary behaviour which justifies the costs of such disclosure.

C. *Investment Function*

Regulations should look to promote corporate governance in an investment fund by mandating the disclosure and maintenance of extensive records of their constitutive and internal governance documents, trading transactions, portfolio investments and positions, investment authorizations and investment advisory materials.[15] Detailed and binding disclosure with respect to the fund's investment function; the fund's objectives, strategies and limitations are required to be disclosed in the fund's prospectus. [6]

Effective disclosure should also focus on the costs attendant to any investment, whether those costs are borne directly by the fund investor or the fund itself. Additional disclosure requirements may be called for to apprise the fund investor of how his or her broker is compensated in the sale of mutual fund shares, including not only the receipt of commissions or sales loads and

[15] Investment Company Act of 1940 § 30(a)(1).
[16] Securities Act of 1933 § 13.

distribution fees paid by the funds them-selves, but also management fee revenues that the fund's adviser may be sharing with the broker.[17]

D. Proxy voting policies ■

Mandatory disclosure of proxy voting policies and procedures as also how potential conflicts of interest between the management of the funds and the investors will be resolved has of late been a widely discussed issue.

Investment management companies, as part of their responsibility of corporate citizenship are expected to play a key role in corporate governance of the portfolio companies. Earlier these investment management companies, especially mutual funds were relatively passive players, although now they have realised that they cannot always easily sell blocks of poorly performing stock, and have instead sought to improve performance in portfolio companies. And, proxy votes have proven to be the principal way to influence the governance activities of a publicly traded corporation. Thus, active participation by such investment companies plays a dual role by benefitting not only to the investors in these investment companies but also the individual shareholders of the portfolio companies. It is hence, not surprising that the disclosure of proxy voting policies has received greater importance.

In the case of mutual funds or other intermediaries, individual investors implicitly or explicitly delegate voting rights to the fund itself. A representative from the fund, typically the investment manager, votes the

[17]Eric D. Roiter, *An Apology for Mutual Funds: Delivering Fiduciary Services to Middle and Working Class Investors*, 23 Ann. Rev. Banking & Fin. L. 851.

proxies on behalf of the individuals invested in the fund. However, since the representative is voting on behalf of the investors, there is a fiduciary obligation to vote in way that promotes the interests of the beneficiary; and the discharge of this fiduciary duty ought to the persons to whom it is owed.

Furthermore, disclosure of proxy votes will assist in the mitigation of the conflict of interest present when an investment company votes proxies for a company with which it has any business affiliation. Disclosure also increases the responsibility on the fund managers and ensures that they vote with a certain degree of seriousness rather than unilaterally 'rubber stamping' management decisions.

III. Indian Legal Framework

There is a comprehensive legal framework which has been developed in India.[19] In 1992, the Government of India decided to open up the business of mutual funds to the private sector. The primary regulations governing mutual funds are Securities and Exchange Board of India (Mutual Funds) Regulations, 1996. Each mutual fund must be authorized by SEBI and shall be operated by separately established asset management companies (AMCs). The SEBI guidelines also prescribe detailed disclosure and reporting. All mutual funds are required to make clear and unambiguous advertisements of the objectives, features, methods and periodicity of investment, valuation.

[18] H. Anne Nicholson, *Securities Law: Proxies pull Mutual Funds into the Sunlight: Mandatory Disclosure of Proxy Voting Records,* 57 Okla. L. Rev. 687.

[19] Aparna Viswanathan, *Indian Capital Markets: An Introduction to Regulation Of Mutual Funds,* (Corporate Law and Practice Course Handbook Series, PLI Order No. 11926 February-March, 2007).

Certificate of Registration by the SEBI - In order to obtain a certificate of registration, the sponsor who establishes the mutual fund must fulfil the prescribed requirements.

In the form of Trust- Mutual funds are in the form of trusts. The trust deed must contain certain mandatory clauses intended to safeguard the interests of the unit holders. The trustees must be approved by the SEBI and can be removed only with the approval of SEBI. An asset management company or any of its officers or employees cannot be appointed as a trustee of a mutual fund. A person who is appointed as a trustee of a mutual fund cannot be appointed as a trustee of any other mutual fund unless such person is an independent trustee and prior approval of the mutual fund of which he is a trustee has been obtained.

The trustees are required, under the trust deed, to appoint an asset management company (AMC) approved by the board of trustees. The trustees must enter into an Investment Management Agreement, containing the prescribed clauses, with the asset management company. The scheme of a mutual fund is managed by an asset management company because a trust cannot, under company law, hold shares in its own name. But the trustee is responsible to ensure that the AMC works diligently. A custodian is appointed to keep custody of the securities and carry out the custodian activities.

Reporting Requirements- Each mutual fund is subject to stringent reporting requirements. On a half yearly basis, the trustees must provide SEBI with the requisite report and certificate of prescribed conduct.

Asset Management Company- The SEBI has to approve the constitution of the asset management company (AMC). In order to obtain such approval, the eligibility criteria of Regulation 21 of the Mutual Fund Regulations need to be fulfilled like the sound track record, adequate professional experience, clean record, non-interested constitution, etc. Further, Regulation 22 prescribes the terms and conditions like a director of an AMC cannot generally be a director in any other AMC, appointment of directors must be by prior approval of trustees, requirements to be fulfilled before making any change in the controlling interest of the AMC, etc.

An AMC is subject to restrictions on its activities and which must be incorporated in the Investment Management Agreement like disclosure to invest, not acting as a trustee of any mutual fund, etc. An AMC may not undertake any business activities except portfolio management services, management and advisory services to offshore funds, pension fund, provident funds, venture capital funds, management of insurance funds, financial consultancy and exchange of research on commercial banks if any of such activities are not in conflict with the activities of the mutual fund, unless as provided. The Investment Management Agreement (IMA) signed by the AMC and the mutual fund must provide that the AMC may not acquire any of the assets out of the scheme property which involves the assumption of any liability which is unlimited or which may result in encumbrance of the scheme property in any way.

One of the most important regulation as regards the corporate governance and control mechanism for an AMC is Regulation 25 which categorically lays down various obligations of an AMC like exercising due diligence and care in its investment decisions, compliance with the regulations and the investment management agreement, liabilities, report submission, disclosure and filing requirements, etc. One important addition was point 6A of Regulation 25 which provides that The Chief Executive Officer (whatever his designation may be) of the AMC shall ensure full compliance and shall also be responsible for the overall risk management function of the mutual fund.

The AMC must disclose the basis of calculating the repurchase price and NAV of various schemes of the fund in the scheme particulars and disclose the same to investors at intervals. The AMC must submit quarterly reports on the functioning of the schemes of the mutual fund to the trustees. The trustees have the right to obtain from the AMC all information concerning the operations of various schemes of the mutual fund.

Disclosure Requirements- The offer document must contain disclosures which are adequate in order to enable the investors to make informed decisions. SEBI has the right to cause the AMC to carry out modifications in the offer documents.

Investment Restrictions and Objectives -The Regulations further provide for specific investment restrictions which must be followed by the mutual funds in order to ensure that the money of the investors is put to the best use.

Code of Conduct- Fifth Schedule of the Regulations prescribes a code of conduct for the Mutual Funds that ensures good governance practices.

IV. Suggestions and Conclusion

A comprehensive reading of the regulations warrants the conclusion that due to its loosely framed language and vague provisions it can be easily circumvented. Thus, the authors propose that the legal framework be amended to provide for inclusive provisions dealing with instances of conflict of interest and specific safeguards.

A. Disclosure

- At present SEBI requires disclosure to evaluate the suitability of a collective investment scheme for an investor and the value of the investor's interest in the scheme. However, what are required are detailed disclosures norms along with enhanced regulation for funds to bring about the much-needed transparency.
- Furthermore, it is suggested that there is disclosure regarding the concentration of unit-holdings and the details of the bulk holders. This information is crucial to reduce vulnerability to large outflows by a handful of corporate investors.
- Furthermore, there should be a requirement to disclose the fees and expenses that are charged by the mutual funds in the prospectus to enable the investor to make an informed choice.

B. Proxy Voting

- As on date, the regulations are inadequate as regards the precautions to be followed in case of proxy voting. In this regard the US "Proxy

[20] Rajesh Gajra, *Mutual Funds: Investing in Transperancy*, available at http://www.businessworld.in/index.php/Markets-Finance/Investing-In-Transparency.html <last visited March 9, 2009>

voting by Investment Advisors" Regulations, 2003 serve as a good example which imposes upon the investment advisor a duty to develop policies and procedure relating to the voting of client proxies, particularly the steps the investment advisor should take in cases where there is a material conflict of interests. Furthermore, there are also stringent disclosure mandates for proxy voting.

C. Involving the Investors

- Although the regulations intend to safeguard the interests of the investors, they provide to do so without principally involving the investors. Despite the application of the concerned provisions of The Companies Act, 1956; the US example of The Investment Company ■• Act, 1940 which specifically granted the shareholders of the investment companies voting rights as regards certain important matters (for e.g. Changing the sub-classification as close-ended or open-ended, underwriting, investment decisions, etc.) should be used as a guiding light to incorporate similar legal provisions in India.

D. Regulation of fees and expenses

- Another significant area that has the potential to generate substantial savings to investors is the reduction of fees and expenses charged by funds which needs stricter regulation. Fees in the nature of exit fees, fees to assist marketing of the mutual funds and other charges levied on the investors significantly cut into the returns fund investors receive and thus, these require to be regulated.

[21] Thomas R. Hurst, *The Unfinished Business of Mutual Fund Reform*, 26 Pace L. Rev. 133.

- Also, to reduce the costs of the agency relationship and promote the efficient operation of a fund by the manager's fee should be based upon the success of the fund.

E. Additional Areas

- The mutual fund regulation sets out provisions governing the broad activities of these funds, not the detailed regulations which will eventually be required to govern many of the technical and financial issues arising in connection with fund operations. Issues such as share offerings; anti-trust; methods to be used in valuing fund assets; specific accounting rules to apply to fund operations; and specific tax regulations to apply to the operations and profits of funds should be given due importance and coverage under the existing legal framework.

Matthew J. Hagopian, *The Engines of Privatization: Investment Funds and Fund Legislation in Privatizing Economies,* 15 Nw. J. Int'l L. & Bus. 75.

Civil Societies in Governance

Dinesh Kothari*

In India, or for that matter all over the world, there are organizations, which undertake responsibility by providing support to not only under privileged, but, also for other causes such as education, health, sanitation and the likes. Government appreciates them and provides them with fiscal (tax reliefs) & financial support. First of all, let us understand why Civil Societies or NGOs came in existence, and what was expected of them. It is not possible for any Government to reach people in grass root level as people live in remote pockets, facing different problem, which may not be of national level, but, at domestic/regional level and different nuances peculiar to ethnic culture, language etc. At the same time, there are kind hearted people, who may not have ability to give cheque donations, but, are willing to give time donation. Therefore, these people become a bridge between Government, donors and beneficiaries, and are able to address and attend to the needs of the society. For example, there may be people suffering from leukemia or blindness, and require help both emotional and financial. Some people might be able to give financial assistance, Government may be willing to extend infrastructure and financial assistance, but, emotional assistance can only be provided by human touch, who have desire to serve the society. Government recognizes this, and therefore, encourage people to set up CSOs/NGOs, and would provide financial assistance to reach the needy. It sounds a great concept, and in fact, it is!! To draw a corollary, primary education in India should be promoted through societies and/or charitable trusts, basically with the intent not to make

* Renowned Management Consultant and Educationist

profit for the operators/promoters of these societies and trusts. In Indian context, this was a good model, but, in the modern times this should undergo a change.

The principle behind setting up of CSOs/NGOs is to ensure that the funds received from Government and/or private donors are strictly utilized for the benefit of people, and purpose for which CSOs/NGOs is set up, and NOT for personal gains and benefit of the organizers/operators of NGO. But, unfortunately not all CSOs/NGOs follow the governance of the charter of incorporation.

There is no formal statute for CSOs/NGOs as is in case of companies, which are regulated under Companies Act, where "Dos" and "Don'ts" are very well defined. Likewise, there is no central body, other than Income Tax Department, where these NGOs need to file their regular financial statement, thus providing transparency of the state of affairs. Governance issue has become more relevant after economic melt down, which world is going through. It has surfaced that one of the major causes of economic commotion has been result of improper governance. Therefore, there is need to have well defined and structured statute to regulate the functioning of CSOs/NGOs.

Since CSOs/NGOs are formed with the basic objective to provide social support to the community, therefore, they should be regulated more by self-discipline rather than only by external regulations. The ultimate test of wisdom, is not knowing what is right, but, knowing what is wrong. Unfortunately, most of these CSOs and NGOs have become vehicles of personal gains, misusing fiscal benefits extended by the Government and public donations, rather than the purpose for which they have been set up.

In my view, the lessons of governance should start in the family, and if the parents will ensure and inculcate value system at home, the children and the generations to come will not have to address the issues of moralities, governance. Unfortunately, in today's times human race has, in fact, indulged into rat-race, and therefore, very visibly we see disintegration of families, the major constituent of the society. Likewise, Government will also have to think more liberally. For example, Primary Education, which has to be set up as non-profit entity, should be opened up for the corporate sector. This will bring quality money in the system and benefit the entire society.

In order to ensure better governance of CSOs/NGOs, it will be relevant that Government should re-address this sector and make stringent regulations for violators, including severe punishment. Let people not make business out of charity, and those who do should be suitably punished. To sum it up, for better governance, there is need for self-compliance, self-monitoring, so that we can march towards better value system in all the walks of life.

Good Governance & Good Performances & Some Corporate Governance Issues

*D. D. Rathi**

The topic of Corporate Governance generally acquires significance under two situations. First, when there has been a string of companies collapsing due to bad governance and second, when there are regulatory changes to enforce corporate governance. Companies genuinely committed to high standards of financial propriety, ethics and disclosure are likely to be practicing good corporate governance. There is generally a direct correlation between good governance and. good performance. Ira Milstein, director of the Yale Centre for Corporate Governance said, *"Good governance leads to good performance. One may not be able to prove that empirically, but I can demonstrate that bad governance leads to bad performance."*

A research study by a leading International Bank based on an assessment of the governance of the FTSE 350 companies using 50 differently weighted corporate governance standards found a clear link between the corporate governance and share price performance of the companies. During the four and a half year period investigated, the top 20% of the companies in terms of governance structure and behavior outperformed those in the bottom 20% by over 32%. A number of financial irregularities and accounting scandals across the globe have made regulators think of new ways to ensure transparency, integrity and accountability. Corporate Governance Codes are constantly being revised. Today, more than any time in our history,

* Executive Director, Grasim Industries

boardroom discussion is focused on issues of governance, accountability and disclosure. The voice of shareholder activism is getting louder and louder and the focus of regulators perhaps is getting more and more intense.

The future course of Corporate Governance is an increasing trend towards convergence. As companies get listed in multiple stock exchanges and carry out operations across several jurisdictions with cross-border financial flows, the need for some commonly understood standards of governance is inevitable. Global capital logically flows to where it is best protected and bypasses where protection is limited or non-existent. Companies with high quality governance mechanisms have a better quality of financial reporting and can get external financing at a cheaper cost, which means overall better performance.

In the Indian context, there is sufficient evidence that we have performed rather well on corporate governance - both on the Corporate regulatory and regulatory front. Governance Association, which ranks 10 Asian countries on Corporate Governance parameters over the last five years, India has consistently ranked among the top three along with Singapore and Hong Kong. To our country's credit, efforts to devise a corporate governance code were not prompted by any serious macro economic collapse but rather intent to follow global best practices. Early initiatives on corporate governance principles, which commenced in 1996-97 came from CII, an industry association, which was followed up by the Regulators. Kumar Mangalam Birla Committee Report in 1999 was the first regulatory measure towards structured Corporate Governance Practices. World over, such initiatives have been the reverse way around. To the credit of our regulators, they have continued to keep a vigilant eye on corporate governance issues.

Perhaps the most far-reaching legislation in the history of the corporate world has been the enactment of the Sarbanes-Oxley Act (SOX). Prior to SOX, under US laws, the CEO was not required to sign the company's financial' statements. SOX made the CEO and the CFO responsible for not only the robustness of the financial statements, but also for having an effect on internal controls and financial reporting. In India, the Companies Act laid the responsibility of financial statements on the Board of Directors. The board is responsible for the "true and fair" position of the Books of Accounts and Financial Statements.

Clearly, the drivers of change in corporate governance standards in India have predominantly emanated from one set of players - the foreign institutional investors (FII). In India, mutual funds play a passive role in corporate governance. Insurance companies and banks are somewhat more active than mutual funds as they do attend shareholder meetings and vote. FIIs tend to exercise their ownership rights more actively, and a sign of satisfaction of the level of corporate governance in India is the fact that FII growth here has been explosive with currently there being over 1,000 registered Flls. A growing number of Investors believe that active promotion of good corporate governance in investee companies increases shareholder value in the long term. Companies with active, interested and involved shareholders are more likely to achieve superior long-term returns than those without.

Let's look at the issue of independent directors. In a comparison between the 50 largest companies in India and United States, it was observed that in the US all the 50 top companies have a majority of independent boards. In comparison, in India percentage of such companies was found to be below 60. Increasingly, Indian companies need directors who can bring skill and experience to the table and knowledge of international markets with particular functional backgrounds. Corporate India is not finding it easy to find qualified, suitable candidates for non-executive directorships and the shortage of qualified independent directors is causing widespread concern. With the governance spotlight on independent directors, here are a few observations and feedback from global independent directors of their changing role, which Corporate India needs to take cognizance of:

A. The Performance and health of the company

Independent directors tend to focus primarily on financial matters, reflecting short-term corporate performance, Majority directors today feel that they need to focus on the longer term health of their companies. On the flip side, there are directors that complain about receiving too much information just a day before the meeting or no information at all and major items are tabled at meetings- these are again danger signs of poor governance. Thus, the challenge for independent directors lies in being able to extract 'relevant information' from the company in time but without being burdened with the details.

B. Time spent at meetings

Here there is a bit of a paradox - on one hand a significant number of directors feel that too much time is spent on onerous issues like compliance and compensation of top management, at another level, independent directors feel they need to divide their meeting time between meeting of the Board and having an interface with senior employees where they can get a real feel for the performance of the business. There is also merit in having the external auditors meet up exclusively with the audit committee, atleast once every six months.

C. Issue on succession planning

Corporate succession should not be viewed as a one-off agenda item, but must be looked at continually. This is definitely a sensitive issue and becomes touchier especially if the board is pleased with the current CEO. There has to be an understanding that CEOs cannot be permanent fixtures and there has to be someone waiting in the wings. As painful as it may be, directors now recognize that a succession plan is crucial to the continuity of the organization.

D. Board evaluation

Not too many directors are comfortable with the idea of being evaluated. No one wants to get a bad-report card and that too from one's peers. But as a director aptly put it, "evaluation hurts, but it is a great help." It is only through an evaluation exercise that the mere 'board sitters' can be distinguished from the 'board contributors'.

E. CEO compensation

While full disclosures of senior management compensation are a welcome step, some CEO compensation packages are indeed eyebrow raising. Often, questioning the CEO's compensation package was found to be very sensitive issue. Executive compensation should be closely aligned with the long-term interests of the shareholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.

F. There is no one-hat-fits-all strategy

Independent directors in India need to develop their own strategy to add value while working on the Boards in our country. Anglo-Saxon Corporate governance model cannot be freely mirrored for a country like ours where values and existing environments are different. For instance, in our country, large portion of public listed companies are families dominated, where family own a majority stake or wield decisive influence. Appointment and remuneration of director is determined by shareholders, thus effectively the decision making rests with the family. It is hard to see independent director getting appointed or reappointed without family's nod. Independent director has to therefore continuously strive to keep a balance and ensure that minority interest is protected through good governance practices.

Gone are the days of when being an independent director was a cozy job, Directors today are more aware of the risk to their reputation and as also of the financial and prosecution risks. This brings in the point on protection against future financial liabilities under the "Directors and Officers Policies". It is hoped that proposed changes in Corporate Laws will also try and address the issue of excessive risks to which independent directors are currently exposed.

Another area of importance is the role of the audit committee. While the revised clause 49 enhances the role of the audit committee, it has substantially increased its workload as well. Further, companies need to guard against audit committees evolving into 'mini-boards' where the roles of the audit committee and main board may become confused. Clearly the relationship between the audit committee and the main board is delicate. World over observers have recognized that legislation and regulation have a limited role in enforcing the spirit of corporate governance. Sheer compliance may not warrant better governance and it is only those companies, which look to adopt measures that go above and beyond their governance obligations, which would be rewarded by the Street. In the long ran, the companies that will command a premium will be those driven by self motivated governance agendas. It is a matter of pride that many of India's leading corporates have chosen to follow this path and it augurs well for Corporate India as we aim to achieve and attain our global aspirations.

Value based organizations have demonstrated that even the so-called soft concepts can be extremely powerful; Money can't buy reputation or integrity; both have to be earned. Organizations based on strongly held shared values amongst its customers and its employees have been able to professionalise and develop their market potential through strong brand loyalty and relationship building with their constituents.

The Companies are to be built on very strong building blocks, which are based on a clearly established corporate commitment to transparency and integrity in all its relationships, internal and external. These values permeate into everything the Corporate does, as well as the manner in which things get done. Methodology is as important, if not more so, than the final product. This approach is needed to be reflected in every corporate's product development, its relationships with its constituents- its shareholders, investors, lenders, suppliers and customers.

Conclusion

Governance is about governing: it is not merely about ownership; even an owner has to learn to govern. Good governance implies that the organization is run for the optimal benefit of all its stakeholders. I would say that ethics have a major role to play in realizing value for your efforts, but what is ethics? I would articulate a one line definition of ethics - "don't do something that you would be ashamed of if it becomes public". And it is not too difficult to achieve this reality. There is no pillow as soft as a clear conscience. Tell the truth and you won't have to remember the lies. It is such a simple concept.

Can Dharma be Protected?

*ShriK. Sampath**

In times as ancient as required words of wisdom to be penned and carved in Sanskrit, someone once said that if one endeavoured to protect Dharma, Dharma would meet that person halfway and render a reciprocal protection, but if one undermines Dharma, then Dharma will inexorably take its toll.

Mahatma Gandhi said as much iu our colonial masters in his characteristically crisp way. He said, *"It is the means which justify the ends and not vice-versa"*.

In the context of our struggle to shake ourselves free from the colonial yoke, this point was moot. We got our independence not because we were stronger or braver or smarter or richer than the British. Though there is a temptingly cynical perspective that would urge that we certainly could talk much more than the British, and did so, it must be fairly stated that we got our independence on moral and ethical grounds. The British carved a swathe through the country so long as we fought with cloak and dagger, but they had no answer to Satyagraha. The power of truth and sense of righteousness gave our people and our leaders the edge, and as for as long as they fought on the side of Dharma, the British, with all their might, stayed firmly on the back foot.

* President, Income Tax Appellate Tribunal Advocates Association, Delhi

Those were good times while they lasted. There was neither power nor money in politics, but freedom fighters came in the thousands only on the courage of their conviction, with no desire for self aggrandisement. No return was contemplated on the investment. The means justified the ends.
Echoing that sentiment while speaking in the constituent assembly, Pandit Jawaharlal Nehru said and I quote:

> "/ *must frankly confess that I am a socialist and a republican, and I am no believer in kings or princes or in the order which produces the modern kings of industry who have greater power over the lives and fortunes of men than even the kings of old, and whose methods are as predatory as those of the old feudal aristocracy. I recognise however, that it may not be possible for a body constituted as is this National Congress, to adopt a fully socialistic programme. But we must realise that the philosophy of socialism has gradually permeated the entire structure of society the world over and almost the only points in dispute are the pace and method of advance to its full realisation. India will have to go that way too if she seeks to end her poverty and inequality, though she may evolve her own methods and adopt the ideal to the genius of her race".*

Pundit Nehru had some very special ideas... the generous deployment of industry with a view to benefiting the poor, and not the rich! And keeping the socialism debate aside, it is an idea that forms even today, the backbone of our industrial structure and our economic growth. It is probably the only programme of poverty alleviation in India that has worked. Even in the context of business, Pundit Nehru made the means not only to justify the ends, but also to fructify the ends. With a modest budget allocation of Rs.200 crores, he established so many industrial organisations and undertakings, in heavy engineering, communications, mining and metals, oil and gas, consumer goods and hospitality, banking and insurance, nearly in every facet of industry and commerce. A nation was industrialised for the nation's sake, and not the industrialists'. For the statistically inclined, it may be relevant to note that with a comparative fortune in Rs. 3 lakh crores, our previous finance minister has failed to establish one single, solitary industry to match Pundit Nehru's crop.

Naturally, the environment of industrialisation and development as fostered by Pundit Nehru's policies permeated to the industrial culture of its times, which saw the emergence of a large number of entrepreneurs in a variety of fields. All of them had only a common call to meet, the call to scrupulously adhere to the objectives of the company without indulging in any questionable methods. To ensure that companies maintained proper accounts and delivered credible reports, the office of chartered accountants and other regulatory agencies was put to extensive use.

The great work which Pundit Jawaharlal Nehru did, of establishing a heavy and indigenous industrial framework was never repeated by his successors. Instead, they set about exploiting those industrial institutions to the hilt, such that many of them had to close down with the passage of time. The departments of income-tax and central excise played a similarly predatory role, creating gargantuan and illegal demands and forcefully appropriating such dues. The few that have survived to this day, are the proverbial NAVARATNAS. They still do excellent work, generate profit for their shareholders, and help the common man grow. They do not sell substandard steel. They compete with the world leaders in heavy engineering goods, and keep India in the hunt when it comes to a competitive advantage on costs and know-how. They put up petrol pumps in commercially unviable areas, knowing that such devices help regions and areas develop. They put up telephone lines without worrying about network usage. They even give loans without hiring collection agents!

A lot has changed since Pundit Nehru's idyllic times. The world has become very competitive. It has both globalised and liberalised. Communication has shrunken the world to the size of a village, and in the village, nations survive on global trade. Until recently, there weren't many takers for business with India. The fear of India's widespread corporate corruption and the mistrust of governmental arm-twisting kept most international business houses at bay. On a perceptual level, this trend was quashed largely by the phenomenon we call Infosys. The redoubtable Narayan Murthy proved to the world that dealing with India was a staunch business proposition. The old values were at work again... Value was created and put in the people's hands. The nation grew as an industry did. The ethics were non-negotiable, and glaringly so. The means justified the ends.

Many observed the success of Narayan Murthy and Infosys, and fashioned their structure and strategy on an analogous basis. Few though were able to manage a successful cloning. Some of them could not last long because their inherent propensity for short-cuts and illusory advantages punctured their further rise. Many did not realise that Narayan Murthy and his ilk were flourishing not because of any inherent luck or because of the help of the forces of expediency, but were scrupulous to the teeth, and would not brook anything questionable in their path.

One such company has recently crashed. It is said that the influence of politicians has a lot to do with the thousands of crores of cash that never were. In its heyday, the company seems to have patronised a politician then in power, and when the bedfellow fell from grace, the company promptly switched sides to the incumbent from an opposing party. Milked by the business of politics, the company today has become a case-study in the politics of business. Had only the means been well chosen, the ends would have certainly been different.

In a nation where corruption is so common, you may find it surprising how people still keep referring to concepts of truth and honesty and fairness. And these people are not opium-headed hermits. The man who said truth is God gave us our freedom. The man who made *'Satyameva Jayate'* a national insignia built our industrial framework as we know it today. These are people who must have faced the hazards of fickle minds and negotiable morals day in and day out, myriad times more than we do, as they set about their work. And they seemed quite clear that they weren't advocating this honesty thing because it made them feel nicer, but because they actually believed it worked better. Then they showed us as much.

They probably gave out the truth slogan as a warning, as a modicum of wisdom from their efforts and endeavours. They were at the cross-roads scores of times, and saw how people who swerved from the straight path shone momentarily and then floundered. Which is piquantly why every rupee carries as a promissory note, the promise of better times ahead if the scruples remain non-negotiable, the promise of Dharma's help if we only take the first step.