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   OBJECTIVES

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   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

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CORPORATE GOVERNANCE IN INDIA: EVOLUTION AND EMERGING ISSUES

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ABSTRACT

Corporate Governance Evolution is a global phenomenon sweeping through the US, Europe, China, Korea, India, Latin America and many other places. These reforms have been accompanied by a surge in corporate governance scholarship focused on emerging markets, special in India, and show the evolution of corporate governance in India. This research suggests, although not uniformly, that "better" corporate law and governance tend to be correlated with better market development, more dispersed ownership structures, and higher firm profitability, amongst other things. These findings have sparked debate and thought on why these correlations exist and whether there are particular features of corporate law and governance that matter more than others to these economic measures. Indeed, recent research in developed markets has begun to focus on enforcement of corporate and securities laws as a critical feature in determining the health and growth of markets.

KEYWORDS

Modern Corporate Governance, Liberalization, Corporate Governance Initiatives, Reforms.

INTRODUCTION

It is strange but true that early initiatives for better corporate governance in India came from the more enlightened listed companies and an industry association. This was quite different from the USA or Great Britain, where the drivers of corporate governance were shareholders' groups, activist funds and self-regulatory bodies within capital markets, or South-East and East Asia, where the impetus for better governance was the result of conditions imposed by the IMF and the World Bank in the wake of the financial collapse of 2008-2009.

The past few years have seen an extraordinary movement by Indian enterprises to sign up for codes of corporate governance; first voluntary, later compulsory. This is not the consequence of any scandal but the direct result of the recognition by a new breed of managers and entrepreneurs that good corporate governance is intimately linked to sound business and opens the road to sources of finance. There is still some way to go: bankruptcy and accounting procedures need improvement, the stock and bond markets need to perform better and pension funds should play a fuller role. But there are real grounds for optimism.

NEED FOR CORPORATE GOVERNANCE

1. Liberalization and competition
2. The need for transparency
3. Corporate law
4. Barriers to investment
5. Tariffs, quotas and taxes
6. Development finance
7. State holdings in private sector companies
8. The emergence of a new generation managers and entrepreneurs
9. Market capitalisation and liquidity

GOVERNANCE IN INDIA

India is a large country with considerable heterogeneity in its population and economic base. India has more than 20 official languages spoken by over 1 Billion people spread throughout roughly 30 states with significant rural and urban populations. The geographic and climatic conditions vary greatly throughout India as do the range of its goods and services.

Politically, India is the world's largest democracy with a variety of political parties and active elections. India possesses both a Central government and State governments. It is a Parliamentary democracy and is currently ruled by a coalition of over a dozen political parties with a resultant premium on consensus decision making. Legally, India possesses a common law legal system, but has a detailed written Constitution that permits the operation of parallel legal systems. These include the Federal (i.e., Central) laws, State laws, religious laws (e.g., for family and inheritance matters) and local, often village, level courts.

CORPORATE GOVERNANCE IN INDIA

Although a legal and government system of considerable sophistication and complexity, it is plagued by an inefficient judiciary, weak infrastructure and frequent complaints of endemic corruption. For many years these factors appeared to contribute to India's rather paltry growth rate post-Independence. However, over the last two decades or so the Indian economy has been one of the faster growing economies. After the major economic liberalization that began in 1991, India's economic policy has become much more market oriented and the country has witnessed fabulous growth rates. For example, India has thousands of firms listed on over 20 domestic stock markets as well as an active private (not publicly traded) corporation sector.

India's economic success is now usually spoken of in the same breath with China's (and other hot emerging markets), yet it is India's economy that have grown so consistently and so much over the last decade.
One might conjecture that the corporate governance situation in India is different than in other places. Indeed, in the last decade India has engaged in an ambitious series of corporate governance reforms, which I discuss in this Part. As we shall see the saga of modern corporate governance in India is, in many respects, a promising start followed by a decline with much more recent attempts at redemption.

THE EVOLUTION OF CORPORATE GOVERNANCE IN INDIA

A. ORIGINS OF MODERN CORPORATE GOVERNANCE IN INDIA (1866 TO 1947)

India, unlike a number of emerging markets, has had functioning stock markets since 1875 where much of the activity was organized in the form of joint-stock limited liability companies. From 1866 onwards there were many pieces of legislation governing corporate governance, trust activity, banking activity, and securities regulation (Bagchi (1972), Rungta (1970)). Moreover, it appears that Indian Industry grew considerably during World War II because the Chinese and Japanese economies, which were in some sense competitors, were damaged by the war and by wartime activities on their territories. Thus, by the time of Independence in 1947, India appeared to have well functioning stock markets, an active manufacturing sector, a large corpus of corporate and securities laws, and a well developed banking establishment (Chakrabarti (2005), Goswami (2003)). Although there were certainly corporate governance abuses, the general state of corporate governance and the overall economy in India placed it in an enviable position amongst many post colonial countries. This position was, however, about to receive some serious setbacks.

B. INDEPENDENCE TO LIBERALIZATION (1947 TO 1991)

Following Independence the Indian government put in place a number of policies that had the effect of weakening corporate governance in India. This started with a series of Industrial Policy Resolutions which entrusted the state with much greater responsibility for managing the economy (Mohan & Aggrawal (1990)). The changes wrought by these resolutions included a much expanded state owned sector. The government was to become the sole provider of many goods and services, which led to the nationalization of certain industries (in particular financial institutions) and the removal of private firms and competition from large sectors of the economy. This would have reduced the competitive pressure to be efficient. Moreover, Indian state owned enterprises (SOEs) were not simply being run to maximize profits, but for a variety of additional reasons as well (Goswami (2003)). In light of this, it is unsurprising that such firms would not focus their corporate governance on efficiency.
This was accompanied by a series of enactments that worked as entry barriers to certain markets and to investment. First, laws were passed that required industrial enterprises to obtain a number of licenses from various government agencies to conduct business or to expand capacity (commonly known as the "license raj") (Goswami (2003)). The requirement to obtain the government's approval provided opportunities for rent-seeking and corruption that likely led to a less competitive environment for many Indian businesses. Second, the government erected large trade barriers and tariffs, imposed limits on how much stock a foreign entity could own in an Indian enterprise, and required firms to purchase their goods from primarily indigenous producers (Mohan & Aggrawal (1990), Goswami (2003)). This insulated domestic firms from foreign competition and, when combined with the extensive licensing requirements, insulated domestic firms from much further domestic competition. The lack of competition would have benefited incumbents, but would also have hindered further growth in corporate governance by reducing the competitive pressure to be efficient.
This was compounded by how private sector firms were capitalized and the incentives of the various capital providers to monitor management. The primary source of capital for many Indian firms was debt capital. This was made available by the state through a variety of state owned and operated development finance institutions (DFIs) (World Bank Report (2005), Chakrabarti (2005), Goswami (2003), Bhasa & Jha (2007)). The employees of the DFIs were not assessed based on whether the firms they provided funding to made a profit, but rather on the total amount of loans that had been made. This, of course, created an incentive to maximize the amount of loans rather than providing loans to businesses with viable business plans. DFIs then had little incentive to monitor management. Indeed, the DFIs often favored management due to a variety of reasons including corruption and political gain.
Although the DFIs were often the primary credit providers, other creditors did exist and could have had some incentive to monitor management. This was, however, hampered by the glacial speed of India's bankruptcy process. There were inordinate delays in the process of restructuring and liquidating a firm (e.g., it could easily take 10 years to liquidate a firm) and this would have placed non-DFIs creditors in an unenviable situation (Anant & Goswami (1995), Goswami (1996)). Indeed, it was not very common for private creditors to provide credit to anyone but large and very well known firms or firms that had government guarantees. Thus, these creditors were unlikely to exercise real oversight over management.
Even if creditors could not or did not monitor management, perhaps shareholders could. Here once again there were problems. First, the primary providers of equity capital were the DFIs. Although most DFIs would invest primarily in the form of debt, they might also invest in the form of equity when their internal debt ratios would prohibit them from investing any more as creditors. Indeed, for many companies the DFIs had collectively well over 50% of the equity stock. However, the DFIs had, as before, little incentive to act as careful monitors of management and used to routinely appoint nominee directors to the boards of these corporations that would rubber stamp management decisions (World Bank Report (2005), Goswami (2003)).
If the DFIs did not exercise oversight, then what about other minority (non-management) shareholders? There were provisions in the Companies Laws for minority shareholders to raise oppression and mismanagement concerns at various adjudicative fora. However, they were unlikely to have their grievances redressed for a number of reasons (Goswami (2003)).
First, the Indian judicial system was full of delays and years could pass before such litigation would be adjudicated. Second, there appeared to be many irregularities in the share transfer and registration process which would have further delayed minority shareholders in bringing their cases. Third, the disclosure of ownership structure and related party transactions was very opaque in India making it even harder for minority shareholders to achieve redress. This was exacerbated by the very high tax rates for corporations and individuals, which led to a tremendous amount of tax evasion achieved by devising highly complicated cross-holding structures. This made ownership structure even more opaque to minority shareholders. Finally, even if someone tried to buy up shares in the corporation from the DFIs the government could block share transfers that might result in a change in the board that the government considered "prejudicial to the interest of the company or the public interest". Given that government (via the DFIs) tended to vote with management one can easily see how this would lead to entrenchment of management and little scope for effective oversight by other shareholders.
Of course, even if non-management shareholders and creditors exercise little oversight it may be that management and promoters had incentives aligned with maximizing wealth. Here too capital structure played an invidious role. Because the DFIs provided so much of the capital (both in debt and in equity) the promoters could maintain control by providing only 3% of a firm's capital (Chakrabarti (2005), Goswami (2003)). With so little invested in the firm the promoters and management had incentives that diverged quite widely from the rest of the shareholders. Indeed, the prospect for self-dealing and moral hazard would loom large in this environment. Such a system should have led to considerable looting by management and many failed companies. Indeed, it did, but the system was insulated from some negative financial and employment consequences due to the slow bankruptcy process and the fact that the state could (and did) takeover failing businesses and keep them afloat to maintain employment. The employment dislocation that would otherwise follow such policies did not immediately eventuate, but at the cost of increasing the effective debt burden for the state (Anant & Goswami (1995)).
Thus, by 1991 the Indian corporate scene had changed considerably from its pre-Independence situation. For SOEs the lack of competition and little profit incentive contributed to the inefficiency of the enterprise and of its atrophied corporate governance. For private firms corporate governance was ineffective for a number of reasons. First, the DFIs as large shareholders and creditors played little to no monitoring role given how their incentives were set up and the political background against which they were to act. Second, the non-DFI creditors could exercise only limited oversight given the very slow pace of bankruptcy proceedings in India. Third, minority shareholders (non-DFI shareholders) faced considerable obstacles in enforcing their rights. Fourth, promoters could start firms by putting up only the smallest sliver of their own capital. When this is combined with the ineffective oversight by other parties the potential for mismanagement and fraud becomes quite large. Moreover, these private firms faced little competitive pressure to improve their efficiency because of the "license raj" system, which limited domestic competition, and the high trade and other barriers limiting foreign competition. Finally, the employment dislocation

that might have been caused by very inefficient management leading to failed firms was not felt in its entirety because the state could take over failing firms and keep their work force employed. This would have reduced the political cost of supporting inefficient management.

This is a recipe for dysfunctional corporate governance and that is precisely what India had. From the outside India had the laws and the legal system to enforce corporate governance but the operation of the system, inconsistent disclosure, and largely ineffective boards of directors led it to be a failing system of governance. Indeed, Indian firms looking for capital had to rely primarily on internal sources or on the capital provided by the DFIs (Bhattacharyya & Rao, 2005, World Bank Report, 2005).

WINDS OF CHANGE – RECENT CORPORATE GOVERNANCE INITIATIVES

There have been two major corporate governance initiative launched in India since the mid-1990s.

1. The first is by the Confederation of Indian Industry (CII) (This is India's largest industry and business association.)
2. The second is by the SEBI

C. LIBERALIZATION AND CORPORATE GOVERNANCE REFORM (1991 TO PRESENT)

The sheer weight and cost of the overall economic and regulatory system came crashing down on the Indian economy in 1991 when the Indian government, in response to a financial crisis, embarked upon a general program of liberalization. Liberalization was to take the form of selling off some of the SOEs and beginning to sell off or rationalize the state's interests in other firms. Further, the DFIs were now to be assessed on "bottom line" measures rather than the amount of loans sanctioned. Moreover, trade barriers were to be reduced, foreign investment permitted (and even encouraged) and the "license raj" to be eased thereby permitting for increased domestic and foreign competition (Goswami (2003), Krueger (2003)). Following this the government created the securities market regulator – the Securities & Exchange Board of India (SEBI) in 1992 – and slowly granted it increasing powers and the mandate to regulate the stock markets in India. This was also significant because SEBI could take on an adjudicatory role and thereby relieve some pressure on the court system and provide more timely resolution of disputes.

It is against this backdrop that corporate governance reform would develop in India. Although the mid-1990s saw the first incursions into reforming the stock markets and governance, the watershed event is generally perceived to be SEBI's promulgation of Clause 49 of the stock exchange listing agreement in 2000.

The first steps toward Clause 49 came in 1998 when the Confederation of Indian Industry (CII) – a large Industry association – proposed a voluntary code of corporate governance for Indian firms. This was followed in quick measure by SEBI forming the Kumar Mangalam Birla Committee (KMBC) to suggest changes in the listing agreement of the stock exchanges to address corporate governance concerns. The KMBC's draft set of recommendations came out on October 1, 1999 and became effective as Clause 49 of the listing agreement with the Exchanges on February 21, 2000 – a stunning 5 months later. Firms failing to meet the requirements of Clause 49 could be delisted. The details of Clause 49 are provided in Appendix 1, but a quick overview is provided below.

Clause 49 had a number of requirements and recommendations and it provided a phased in implementation schedule wherein certain firms (e.g., Group "A" firms or larger firms) were expected to comply earlier than mid sized firms which were expected to comply earlier than smaller firms. Clause 49's requirements included:

1. Minimum percentages of independent directors (50% or 33% depending on whether the Chairman was an executive director),
2. Tightening up the definition of "independence",
3. Mandating the number of board meetings per year,
4. Developing a code of conduct,
5. Imposing limits on the number of directorships a director could simultaneously hold,
6. Enhancing the power of the audit committee by requiring financial literacy, experience and independence of its members, and by expanding the scope of activities on which the audit committee had oversight,
7. Certifications by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of financials and overall responsibility for internal controls,
8. Enhanced disclosure obligations (on many things including accounting treatment and related party transactions), and
9. Enhanced requirements for holding companies when overseeing their subsidiaries.

These changes appear aimed at making boards and audit committees more independent, powerful and focused monitors of management. Moreover, the enhanced disclosure would aid institutional and foreign investors in monitoring management as well. Clause 49 was received with much fanfare and has been the subject of many conferences, events and debates on its reach, application and interpretation.

Following Clause 49 a number of further committees were formed which led to further changes in the listing requirements (e.g., Y.H. Malegam Committee, Narayana Murthy Committee, Naresh Chandra Committee). Some of these changes came into effect in 2004. Also, during 2004 the Indian government amended the Securities Contracts (Regulation) Act 1956 wherein section 23E now imposed larger financial penalties for violations of the listing agreement (up to Rs. 25 crore (roughly US$ 6,250,000) for a violation). This was a significant increase in penalties from the initial penalty of de-listing for violations of Clause 49.

By 2005 amendments were being proposed to the Statutory Companies Law based on the J. J. Irani Committee's (2005) recommendations. If adopted, the statutory law would permit greater customization and self regulation (e.g., requiring shareholder approvals for executive compensation). Moreover, there would be greater protections for smaller shareholders, especially in merger transactions. Finally, the process of enforcement is to be streamlined, the bankruptcy system upgraded, and the actual legal provisions rationalized and simplified (eliminating redundancies and so forth). The changes will apply to all firms in India (not just those listed on the exchanges as with Clause 49). The proposed changes are summarized in Appendix 1 and compared to the changes wrought by Clause 49. These changes are not inconsistent per se with Clause 49 given that Clause 49 only applies to a subset of firms (listed firms) subject to the Irani committee's recommendations.

Since 2005 there has not been much in the way of changes to either the listing agreement or the Statute, but in September 2007 SEBI initiated its first enforcement and investigation proceedings against firms for violations of Clause 49. It is noteworthy that the first enforcement actions were brought nearly seven years after the promulgation of Clause 49 and to date no penalties have been imposed. Finally, just recently the Indian Cabinet has approved the Irani Committee's recommendations and statutory law changes are thus visible in the near horizon.

There are many important and perhaps remarkable features of the Clause 49 reform process. The first is that the reform process was initiated and supported by private industry (i.e., the CII) rather than triggered by an Enron-like scandal (Goswami (2003)). This is somewhat unusual because governance reform tends to place constraints on what managers and controlling shareholders can do. Given that these people make up the power structure of Indian Industry it seems odd that they would support placing constraints on themselves.

However, in India, industry pushed for governance reform because access to capital was necessary to take advantage of the opportunities created by liberalization and to stay ahead (or at least with) the competition. Obtaining capital from domestic and foreign investors would have been difficult without some greater assurances (given the poor track record of the capital markets since Independence and the debilitated state of governance). Moreover, given the likely low level of interest (and perhaps available capital) from domestic investors, industry may have had to approach foreign investors for the bulk of their funding initially. The CII voluntary code in many respects appears designed to attract foreign investors to Indian firms as many of its provisions were based on "best practices" at the international level.

However, the voluntary code was not perceived to have generated a very high level of foreign investor interest. Enacting the CII code as law might be necessary to bolster the credibility of governance reform. Indeed, we see CII lobbying SEBI to enact some governance reform less than a year from the announcement of its voluntary code. Presumably, making governance part of the law would enhance its credibility and probably provide some enforcement for it. Thus, the corporate governance reform movement was motivated by a desire to raise capital from foreign investors to fund investment in new business opportunities or to enhance chances in current endeavors. With industry, the primary opposition to reforms normally, supporting them it is not surprising that the reforms came swiftly. Reform was also supported by the increasing presence of foreign investors, the Indian financial press being quite active, and the desire to access US capital markets (Goswami (2003)).

Another important feature of the Clause 49 reform process was the gradual escalation of sanction severity. Initially, the penalty for non-compliance was de-listing (2000) then some years later more severe financial penalties became available (2004) and then finally enforcement actions some years later (2007-08). This is perhaps not too surprising.

Starting with the less severe penalties (i.e., de-listing) may have dulled opposition to the reforms. Moreover, listing requirements are generally enforceable only through SEBI and the Exchanges which can utilize enforcement discretion thereby softening the impact of the changes. One might, of course, wonder what opposition was there to the reforms given CII's active encouragement of them? However, simply because CII supported these reforms does not mean that all of Indian Industry was in favour of them. For example, the faction(s) that had the critical say in CII may have favoured reforms, but there may have been some who were not as enthusiastic about them. In light of this, a strategy of first changing listing requirements looks very much like an attempt to "test the waters" in a relatively low cost way and then if the change "sticks" to proceed with statutory changes thereby providing firms with sufficient time to adapt before penalties became more significant. Such a strategy is less likely to encounter political opposition, provides time for incumbents to adapt, and may still provide enough assurances to encourage foreign investment in India.

This leads to another interesting part of the process – the weak sanctions and enforcement in India stand in contrast to many other countries that engage in law reform and start with strict enforcement to attract investors. One suspects these countries must do this because the motivation for the reforms is some large scale fraud (e.g., Enron) which may then necessitate visible enforcement actions to restore investor confidence. However, in India visible enforcement actions were probably not as necessary to attract investors because such scandals were not the immediate reason for promulgating the reforms. Indeed, industry support for the reforms may have even lessened the pressing need for enforcement to convey that changes in governance were credible.

EVIDENCE ON RESPONSES TO THE REFORMS

Having described the Clause 49 reforms the next natural question becomes what effects have these reforms had? There are a handful of studies examining the impact of corporate governance reforms in India. The tenor of these studies is that the Clause 49 reforms were received positively by the market and were generally effective at helping to raise capital for Indian firms.

An early study by Bhattacharyya and Rao (2005) examines whether the adoption of Clause 49 predicts lower volatility and returns for large Indian firms. They find insignificant results for volatility and mixed results for returns.

Black & Khanna (2007) conduct an event study of the adoption of Clause 49. They rely on the phased implementation schedule, in which "large" firms were required to comply before "small" firms, and report positive returns to a treatment group of large firms relative to a control group of small firms, around the first important legislative announcement.

Balasubramanian, Black & Khanna (2008) conduct a detailed survey of Indian firms to assess whether better governance practices are correlated with better firm performance (e.g., Tobin's q). Their survey obtained responses from 370 firms (a 73% response rate) in 2006. Their findings are that better governed firms tend to have higher Tobin's q.

Dharmapala & Khanna (2008) examine whether the firms subject to Clause 49 performed better (as measured by Tobin's q) than unaffected firms after it became known that serious financial penalties might attach for violations of Clause 49 (which was in 2004). They find that the firms affected by Clause 49 had higher Tobin's q right after 2004. This suggests that the threat of serious financial penalties had a significant impact on firm value. Indeed, this paper provides compelling evidence of the reforms causing increases in firm value in India and that the enhanced sanctions/enforcement provisions in 2004 may have had a more significant impact than the substantive laws reforms enacted in 2000.

Of course, other measures might be used to assess overall governance practices in India. Minority shareholder expropriation is an important issue in India with a large number of controlled firms. Khanna, Kogan and Palepu (2006), study instances of minority shareholder expropriation by Indian firms and Bertrand, Mehta and Mullainathan (2002) provide evidence on tunnelling within Indian business groups. Dharmapala & Khanna (2008) examine whether the tunnelling risk within Indian business groups changed after the Clause 49 set of reforms. Their initial evidence indicates that tunnelling dropped to very low levels around the announcement of the substantive reforms (1999-2000) and has more or less stayed there since then. Of course, there are other methods of insider expropriation besides tunnelling within business groups, but those are not measured by the Dharmapala & Khanna (2008) study.

Thus, the Indian evidence suggests that Clause 49 has had positive effects on the Indian markets. That raises an important question – why? What features of Clause 49 have been important? Given that most of the Clause 49 reforms were already present in the CII voluntary code it would appear that it was not simply the actual provisions per se that were valuable, but the threat of enforcement (and perhaps legitimacy or signals) the law provided via Clause 49. If the provisions themselves were all that mattered then industry would have been able to raise the desired level of capital with the voluntary code. The presence of the same provisions in a law seemed to matter quite a lot, suggesting that enforcement was critical.

CONCLUSION

Although corporate governance has been slow in making its mark in India, the next few years will see a flurry of activity. Recent corporate governance research is turning to examine which aspects of corporate governance matter most to growth. Although scholarly attention is now focused on enforcement, there is little examination of how the reforms and enforcement may matter in an *emerging market*. Such an examination is important because emerging markets usually have weaker enforcement, but many of them appear to benefit from governance reform.

India will soon move to full capital account convertibility. When that happens, an Indian investor will seriously consider whether to put his funds in an Indian company or to place it with a foreign mutual or pension fund. That kind of freedom will be the ultimate weapon in favour of good corporate governance. Thankfully for India, the companies that matter have already seen the writing on the wall. Thus it may not wrong to predict that, by the end of 2020, India might have the largest concentration of well-governed companies in South and South-east Asia.

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