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The Global Association of Financial Institutions

IIF Equity Advisory Group

Corporate Governance in India

An Investor Perspective

Task Force Report

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PREFACE

In view of the importance of portfolio equity flows to emerging markets, the Institute of International Finance (IIF) established in January 2001 the IIF Equity Advisory Group (EAG) consisting of senior executives from leading asset management firms throughout the world. The EAG, chaired by Edward Baker, Chief Investment Officer of Global Emerging Markets, Alliance Capital, Ltd., is seeking implementation of its Code of Corporate Governance in key emerging market countries that are of particular interest to the Institute's membership base. The IIF Code, which was first released in February 2002 and revised in May 2003,[1] endeavors to improve the investment climate in emerging markets by establishing practical guidelines for the treatment of minority shareholders, the structure and responsibilities of the board of directors, and the transparency of ownership and control of companies.

The strategy for promoting the implementation of the IIF Code, as the standard by which the company/shareholder relationship is measured, is country-focused. Country Task Forces have been set up for Brazil, China, India, Lebanon, Mexico, Poland, Russia, South Africa, South Korea, and Turkey.

In November 2005, the India Task Force held meetings in Mumbai and New Delhi with senior officials from the government, the Reserve Bank of India, the Securities and Exchange Board of India (SEBI), the Bombay Stock Exchange (BSE), the National Stock Exchange of India (NSE), private companies, rating agencies, law firms and consultancies involved in corporate governance. Task Force members in attendance included Manish Singhai, Alliance Capital Management, and Keith Savard and Rakhi Kumar of the IIF staff.

The aim of this report is to offer an assessment as to where India stands relative to the investment environment that members of the IIF Equity Advisory Group would like to see develop in key emerging market counties. This report is not meant to provide an exhaustive due diligence of corporate governance in India and, as with other Task Force Reports, neither the Task Force nor the IIF can in any way attest to or guarantee the accuracy or completeness of the information in the report.

[1] Investors' poor experience in a generally weak corporate governance environment in many emerging markets led to relatively strict and comprehensive original IIF guidelines. Nevertheless, more detailed standards were considered desirable in a few areas in light of far-reaching new legislation such as the Sarbanes-Oxley Act passed by the U.S. Congress in the summer of 2002. The revised standards offer guidance to emerging market officials as they decide what rules and regulations must be put in place to satisfy investors.

SUMMARY APPRAISAL

Historically, India has had an active equity market. There are approximately 6,000 listed companies and over 40 million people invest in shares and mutual funds in the country. Total market capitalization of India's stock markets as of December 30, 2005 was $546 billion. The top ten companies account for more than one-third of total market capitalization. **Seen from the perspective of the IIF Code, the corporate governance framework in India as it applies to listed companies is above average compared to other emerging market economies surveyed by the IIF.** The Securities and Exchange Board of India (SEBI), the independent capital markets regulator, has made significant efforts to keep up with changing corporate governance practices in leading equity markets around the world, namely the United Kingdom and the United States. In October 2004, SEBI revised existing corporate governance requirements to incorporate selected features of the Sarbanes-Oxley Act. Indian companies were required to be in compliance with these new requirements, introduced in Clause 49 of SEBI's listing agreement, by December 31, 2005.

Improvements in corporate governance in Indian companies seem largely to be voluntary and driven by globalization. In India, there is a general belief that financial markets reward good corporate governance practices through access to cheaper capital and higher stock prices. Indian companies have been increasingly attracting foreign capital either through listing on international stock exchanges or through private equity placements and foreign institutional investments. Some Indian companies were early adopters of good corporate governance practices, and companies like Infosys Technologies (Infosys) serve as examples of how equity markets reward well-governed companies.

Companies that wish to access markets for capital or that wish to become leading global suppliers to corporations in developed markets are becoming increasingly transparent and are more willing to adopt higher corporate governance standards. Similarly, companies that wish to become multinationals by acquiring businesses globally are also improving their corporate governance. Many Indian companies realize that the probability of getting board and shareholder approval for a merger or an acquisition is greater when the acquiring company has good corporate governance. **These governance changes are having a trickle-down effect on smaller Indian companies.** Unlisted medium-cap companies, driven by the desire to go public in the future, are slowly embracing better corporate governance practices. Several family-owned companies that have been around for two or three generations have also begun tackling their corporate governance problems by training the younger generation of managers from the family and by introducing family councils to deal with disputes. **However, the pace of change in smaller, unlisted companies and most companies in the government-controlled sector (also called Public Sector Units or PSUs) is generally slow.**

Stock exchanges are viewed as being at the front line of the surveillance function for compliance with all listing requirements, including those that pertain to corporate governance. India has 22 recognized stock exchanges, the two most important being the Bombay Stock Exchange Limited (BSE) and the National Stock Exchange of India Limited (NSE). Clause 49 requires companies to file a quarterly compliance report with the stock exchange. The stock exchange in turn is required to file an annual compliance report with SEBI

for each listed company. Quarterly reports due on March 31, 2006 will begin carrying compliance information with the new governance listing requirements. **Neither the stock exchanges nor SEBI have increased staff as needed to effectively scrutinize compliance with Clause 49.**

Compliance reporting in India is based on a 'check the box' approach, where companies have to check 'yes' or 'no' to indicate compliance with listing requirements. Questions are raised by the stock exchanges only when a company checks the 'no' or non-compliant box. If a company has checked 'yes,' in general, limited effort is made to ensure that a company does indeed comply with requirements. **This gives non-compliant companies the opportunity to check the 'yes' box to avoid raising red flags.**

Although stock exchanges in India have responsibility for surveillance, they do not have the authority to take punitive action against errant companies. That authority vests with SEBI, which can impose fines of up to $5.5 million. The largest fine to date imposed by SEBI has been for $0.2 million. SEBI has a fraud investigation unit but it cannot take any criminal action against errant managements or boards of directors. Authority to pursue criminal action lies with the Ministry of Company Affairs, a government agency that has the ultimate responsibility to supervise compliance with the Companies Act of 1956. In addition to SEBI, the Reserve Bank of India (RBI) has regulatory authority over companies in the banking and financial service sectors, while the Insurance Regulatory and Development Authority (IRDA), a regulatory body, has authority over companies in the insurance industry.

Because of this segmented regulatory structure, **authority and responsibility for surveillance and enforcement is divided among various entities. As a result, a mismatch between the level of authority and responsibility is commonplace**. The cost of non-compliance in the form of fines, legal action and de-listing is low and has proved to be an ineffective mechanism to deal with errant companies. SEBI has been largely unsuccessful in prosecuting individuals and companies brought to trial for non-compliance. SEBI personnel need adequate training to develop skills required to build strong cases against errant companies. It is important that SEBI successfully prosecute non-compliant companies and individuals if they wish to be viewed as a powerful regulator. The current system of enforcement in the country is viewed as weak and entrenched in bureaucracy. In addition, the ultimate justice delivery system for investors – the court system – lacks effectiveness due to large case volumes.

The authorities are working diligently to improve the country's corporate governance framework. The latest reform being undertaken is the overhaul of the Indian Companies Act of 1956 (amended as recently as 2002). A bill to adopt a new act is currently awaiting approval by the Indian parliament and could be adopted as early as February 2006. If the bill passes, the voluminous provisions in the current act would be reduced by roughly two-thirds. The major change proposed in the new Companies Act is the simplification of procedures by moving to a rules-based system. The current Companies Act legislates almost all operational procedures in companies such as incorporation, issuance of capital, winding up etc. Under the new Companies Act, these procedures will no longer be legislated by law but instead be based on rules to be prescribed by authorities. It is uncertain which authority will prescribe the rules.

The India Task Force views this ambiguity with concern. **Although the new Companies Act is intended to simplify procedures, smooth implementation and achieve higher compliance, the ambiguity about which authority will prescribe the rules may well lead to duplication. Moreover, given the level of reported corruption (and lack of enforcement) within the lower levels of the Indian bureaucracy, the changes would likely increase administrative costs for companies initially.** The government should clearly define roles and responsibilities for rule-setting before adopting the new Companies Act to avoid confusion and limit an increase in administrative costs for companies.

On balance, India's corporate governance policy framework is above average and moving in the right direction, though weak surveillance and enforcement practices slow down the pace of improvements. The Task Force believes that further improvements in Indian corporate governance practices require the following actions:

- Encourage better compliance with listing requirements by substantially increasing the cost of non-compliance
- Strengthen surveillance mechanisms
- Introduce sector-specific corporate governance best practices
- Increase shareholder activism in the country by undertaking pension reforms
- Pursue legal reforms to provide investors with a mechanism by which they can redress grievances in a timely and cost-effective manner

KEY CORPORATE GOVERNANCE ISSUES

Meeting the challenges of a well-developed equity market

India's equity markets are well developed compared to other emerging market countries. The Securities and Exchange Board of India (SEBI), an independent judicial body, regulates the exchanges. **Corporate governance-related listing requirements in India are largely based on recommendations of the Cadbury and Higgs Reports and the Sarbanes-Oxley Act. SEBI has been proactive in keeping India's corporate governance rules and regulations in line with best practices around the world.** In 1999, SEBI appointed the Kumaramangalam Birla Committee to recommend improvements to the corporate governance framework. In 2002, SEBI updated its listing requirements with Clause 49, which has mandatory and non-mandatory corporate governance provisions. These listing requirements were again changed in 2004 to incorporate some best practices laid out in the Sarbanes-Oxley Act. All listed companies are required to be in compliance with Clause 49 by December 31, 2005.

Although the corporate governance framework in the country has been improved, **the latest reforms as prescribed by Clause 49 have weak enforceable penalties for non-compliance**. **The severest penalty for non-compliance with Clause 49 is the de-listing of a security. However, under current practices companies are seldom de-listed.** Regulatory authorities view de-listing as hurting minority investors by taking away their ability to exit equity markets. As a result there are over 1,000 non-compliant companies (approximately 20 percent of total companies) listed on the BSE. Although these companies account for less than 5 percent of total market capitalization and have little or no trading volume, the reluctance of regulators to take action against errant companies raises concerns regarding the enforcement and surveillance mechanisms in the country.

As a positive, SEBI has also issued regulations relating to the acquisition of significant shareholdings, takeovers, share buy-backs and insider trading. Bankruptcy laws and anti-competitive laws are also in place. **There is currently a bill in Parliament to revamp the Companies Act of 1956**, which was amended as recently as 2002. **The bill proposes to simplify procedures by moving to a rules-based system.** If the bill passes, the voluminous provisions in the current act would be reduced by two-thirds from the present roughly 780 provisions. However, it is unclear who will have the authority to set the rules. **The India Task Force is concerned that if the new rules are set by civil servants this could increase red tape.**

With the adoption of SEBI's Clause 49, corporate governance requirements in India as written now compare favorably with the IIF code and comply with over two-thirds of policies recommended by the IIF. In addition to mandatory requirements, Clause 49 provides a list of non-mandatory requirements, which promotes governance practices such as creating a board level remuneration committee, training for board members, conducting board member evaluations and establishing whistle blower mechanisms. Companies are required to provide information regarding their governance practices in a separate Corporate Governance section in the Annual Report to Shareholders in which non-compliance with any mandatory requirements, and the extent to which non-mandatory requirements have been adopted, should be highlighted.

Globalization, a catalyst for change

The state of corporate governance in India has improved over the last four years, particularly among large cap Indian companies. Improvements in corporate governance include increased transparency with regard to accounting and financial information and, to a lesser extent, more independent directors on boards. Although Clause 49 mandates many of these improvements, Indian companies were voluntarily improving corporate governance even before the requirements of Clause 49 came into effect for listed companies.

In many large Indian companies, globalization—and not regulatory requirements—has served as the impetus for adoption of corporate governance best practices. The motivation to voluntarily improve the internal governance structure of a company can be attributed to the following:

- **Need to access foreign capital.** Companies seek to access capital either through listing on a foreign stock exchange such as the LSE, NYSE or NASDAQ or by attracting private equity, foreign institutional investors or joint venture partnerships.
- **Need to become a reputable company to export globally.** Many Indian companies, especially those that wish to export goods or services to companies in developed markets, realize that buyers are more comfortable working with companies that have the transparency and ethics levels found among suppliers in developed markets.
- **Desire to become multinational companies.** In their quest to become multinational companies, successful Indian companies generally have been willing to improve their corporate governance structure in order to acquire business or assets in foreign countries. Indian companies have increasingly realized that the shareholders and boards of directors of foreign companies consider the corporate governance structure of the bidding company before approving the sale or merger of an asset.

The trickle-down effect

Infosys, a highly successful information technology provider, was one of the first Indian companies to voluntarily adopt high standards of corporate governance. The founder-promoter and largest shareholder of the company, voluntarily added truly independent directors to Infosys' board, improved financial transparency through better disclosure in accounting statements, and ensured compliance with recommendations of the Higgs Report and Sarbanes-Oxley Act. For these efforts, Infosys stock is much sought after by domestic and foreign investors.

Some other Indian companies have also improved their governance practices. For example ICICI Bank improved transparency around its financial reporting when it raised foreign capital. The Tata Group, one of India's oldest family-owned business, has adopted better corporate governance practices compared to many other Indian conglomerates by moving to a holding company structure and adopting an explicit ethics code of conduct. Similarly the Housing Development Finance Corporation Ltd. (HDFC) has adopted a socially responsible focus in their lending practices since inception.

High market premiums that the stocks of these companies command has reinforced the belief among Indian investors and, more importantly, other Indian companies that better corporate governance contributes to a high stock price and provides access to cheaper capital. This trickle-down effect is now permeating throughout the medium-cap Indian companies who are willing to improve corporate governance to increase shareholder value. Some unlisted companies planning to launch an IPO or attract private equity capital are adopting Clause 49 listing requirements. This change, however, is proceeding slowly.

Corporate Governance problems cut across public and private sector

The Indian government owns significant stakes in several businesses ranging from oil and gas companies to banks. The public sector has been shrinking in size over the years due to the government's privatization efforts. However, **recent privatization efforts have been suspended due to political opposition from the leftist parties within the ruling coalition. Nevertheless, the need to continue reforming India's public sector units (PSUs) should not be halted while they await privatization**. Better corporate governance structures in PSUs will likely increase the sale value of these companies, thereby realizing greater revenues for the exchequer. Corporate governance-related reforms that need to be implemented in the PSU sector include:

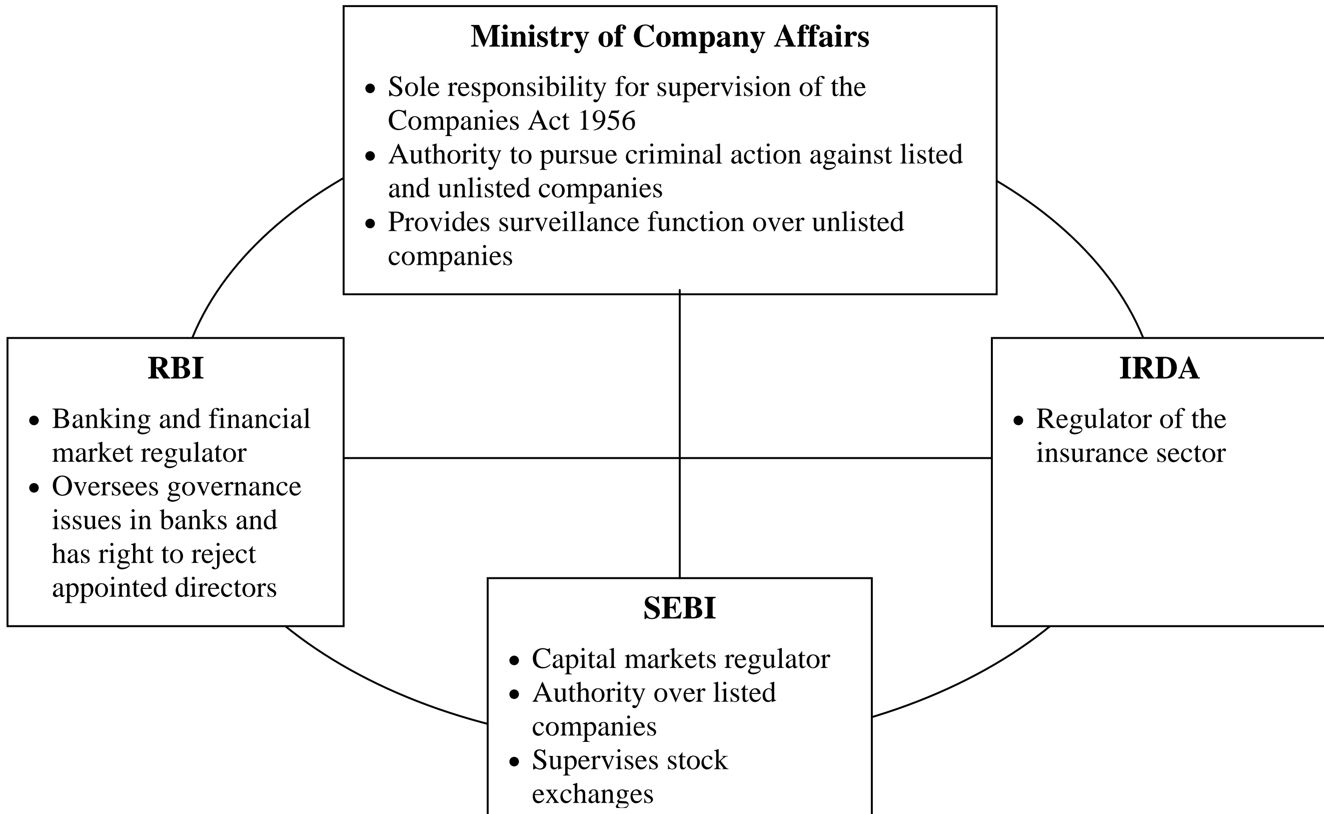
- Increased autonomy for management
- Independent board-level nomination committees to appoint directors
- Reduced interference from sector Ministers
- Focus on profitability by linking senior management compensation to performance

In the private sector, most large Indian companies are family-owned conglomerates manufacturing items from cars to watches. Indian conglomerates have been successful in competing against multinational corporations by streamlining costs and rationalizing businesses. However, **the broader corporate governance structure in Indian companies generally remains poor. The ownership structure of individual companies within the conglomerates is usually opaque. Often the controlling family retains control by creating complex cross-holdings among subsidiaries. Related-party transactions among subsidiaries and, in particular, related lending is a concern.** In addition, ownership of Indian family-controlled companies is moving into the second or third generation. Reforms need to be tailored to address the specific concerns facing the family-owned conglomerate structure. It is important that, among other things, family-owned companies focus on:

- Voluntarily adopting mechanisms for governance of the family's ownership stake; for example, creating family councils that deal with family disputes
- Reforming company boards by increasing overall board independence and reducing the number of family member-directors
- Limiting the role of family members in senior management
- Increasing transparency around the ownership structure and related-party transactions

Complex and divided regulatory system impedes surveillance and enforcement functions

SEBI, the Reserve Bank of India (RBI), and the Insurance Regulatory and Development Authority (IRDA) supervise India's equity markets. The Ministry of Company Affairs has the ultimate responsibility for ensuring compliance with the Companies Act of 1956. The equity market regulatory structure in India is illustrated below.



Although noteworthy efforts have been made to improve the corporate governance framework as it pertains to existing laws and requirements, less has been done to revamp existing surveillance and enforcement functions. Beginning March 31, 2006, listed companies will at the end of every quarter submit information regarding compliance with Clause 49. Stock exchanges will be required to scrutinize the compliance reports and send an annual compliance report to SEBI based on their findings.

However, the compliance reports submitted by companies will follow a 'check the box' (yes or no) approach. Companies will not be required to provide backup information or explain why they are or are not in compliance with the listing requirements. Red flags will be raised only if a company has checked 'no,' indicating non-compliance with a particular listing requirement. **Compliance audits conducted by the stock exchanges and regulatory authorities will not be designed to ensure that a company does indeed comply with requirements.** This leaves room for companies to abuse the system by falsely checking 'yes' in

order to avoid raising red flags. **In addition to the limited scope of compliance audits, staffing levels and training in the compliance departments appear to be inadequate.**

An e-governance initiative is currently underway at the Ministry of Company Affairs that will allow companies to file reports electronically. E-filings will reduce paperwork and hopefully alleviate some of the red tape that currently exists within the system. It will also enable stock exchanges and regulators to use technology to aid in the surveillance process.

With regard to enforcement, there is a mismatch between the level of authority and responsibility among regulators. Regulators often share supervisory responsibilities with each other. However, this over lapping of responsibility can sometimes hamper enforcement efforts. For example, a bank that is listed on a stock exchange will fall primarily under the purview of the RBI; SEBI will have regulatory responsibility with regard to its activities as a listed company; and the Ministry of Company Affairs will have authority to take criminal action for non-compliance with the Companies Act. Each regulator will act within its limited scope of supervision and inform the co-regulator about action that needs to be taken under their purview. With authority and responsibility for surveillance and enforcement divided among various entities, the scope and willingness to take action can get diluted. As a result, **the overall system of surveillance and enforcement in India is relatively weak.**

Delivery of justice by the court system is slow

Courts in India are the ultimate justice delivery providers for minority shareholders. Although laws in India are generally comparable to those in the United Kingdom,[2] **the court system is seen as inadequate to handle the volume of cases being brought to trial.** This results in delays in the delivery of justice. Verdicts are sometimes given 10 to 20 years after the incidences occur. **This is one of the main reasons that shareholder activism has not taken hold in India, as minority investors are not willing to wait decades for redress.**

As reported in the press corruption is present in the court system, especially in the lower courts, which further delays the delivery of verdicts and increases the cost of litigation. Also, judges in lower courts who preside over murder trial are expected to be conversant with corporate law and preside over white-collar crimes like fraud. **An amendment to the Companies Act of 2002 required the establishment of special courts to handle securities- and finance-related crimes.** Three years after the amendment, the government is still in the process of identifying and appointing qualified judges. The establishment of separate courts for white-collar crimes is a step in the right direction but the infrastructure of these specialized courts have to keep pace with growth in the needs of the market to ensure that these newly created courts can dispense justice in a quick and efficient manner.

[2] India's legal system was created by the British and therefore laws are similar to those in the UK.

Corruption

As has been widely reported in the media, corruption in the lower levels of Indian bureaucracy makes the overall business environment less than attractive to investors, particularly foreign investors. Based on the 2005 Corruption Perception Index developed by Transparency International (where the higher the number the greater the level of perceived corruption), India ranked 88 out of 158 countries. On a scale from 0 to 10 (with 0 being highly corrupt) India scored a 2.9. In another report by transparency international that focuses solely on the perception of corruption in India, 60 percent of those surveyed believed that corruption will further increase in the next three years.

Corruption in India has to be tackled by the government if the overall governance structure is to improve. There is a general belief among Indians that the powerful can get away with non-compliance. The move towards e-governance (i.e. electronic filing systems) is a small step in the right direction and can help reduce some of the 'delays' in transferring and filing papers when approvals are sought from multiple regulators. A centralized system or database would also make it difficult for individual officials to make 'corrections' for bribes as changes leave a trail. **The combination of increased cost for non-compliance and greater use of technology for reporting and filing will help reduce some of the corruption in the system.**

Lack of shareholder activism

Shareholder activism in India is practically non-existent. There are several explanations for the lack of shareholder activism in the Indian equity market:

- **Large number of tightly controlled companies**: In India promoters typically retain control of companies by owning a small, yet significant, ownership stake in companies. Shares not owned or controlled by the promoter and his family and friends are widely dispersed, making it difficult for minority shareholders to voice their concerns.
- **Lack of institutional share ownership**: Although FII's increasingly own a large number of shares in Indian companies, in general, no single minority shareholder owns enough shares to significantly influence change. Therefore, even though there are laws that empower shareholders controlling 10 percent of equity, the dispersed nature of ownership of shares makes it difficult for minority shareholders to benefit from the low threshold levels that allow for taking a more active role in the management of the company.
- **Limited investment scope for pension/insurance companies**: Pension and insurance companies in India are owned by the government and constitute a large part of the PSU sector. The Indian government has only recently begun allowing private sector companies to engage in these activities. The government strictly regulates the instruments in which pension funds can invest. Some companies like LIC and UTI have significant stakes in Indian companies but are not activist shareholders. As a result in India there is no large institutional shareholder engage in shareholder activism through its investment decisions like Calpers in the United States.

- **Weak court system**: As mentioned above, the time taken to deliver verdicts through the court system in India is inordinately long. This acts as a deterrent for minority shareholders to pursue legal action against companies.

Pension reforms are required to create a class of Indian institutional investors who will further the cause of minority shareholders and help strengthen corporate governance in Indian companies. In addition, the framework to pursue class-action lawsuits against companies needs to be strengthened. Class-action lawsuits are a powerful mechanism through which minority shareholders can collectively seek compensation for corporate wrongdoings by controlling/managing shareholders.

OUTLOOK AND RECOMMENDATIONS

The corporate governance framework in India as it pertains to laws and listing requirements for companies is robust and in line with the IIF's guidelines. **The India Task Force expects corporate governance structures in Indian companies to improve further going forward. Our expectation is based on the willingness of Indian companies to voluntarily improve their corporate governance to attract capital.** As foreign direct investment flows to India continue, medium-sized Indian companies should be more willing to embrace better practices to gain access to foreign capital.

Several individuals that were interviewed by the India Task Force were optimistic about the corporate governance environment because of two factors—a generational shift occurring in the Indian economy and a more active press. The generation of young professionals in India, having worked in large multinational corporations, have greater exposure to western-style corporate governance. There is a feeling among the 'older' generation that this 'new' generation believes in doing things right. The common belief is that as this new generation matures and is appointed to managerial roles in organizations they will pursue and insist on higher corporate governance standards.

In India, an active free press has partially substituted for the lack of shareholder activism. Increased competition in the media industry has resulted in journalists and news channels conducting sophisticated financial analysis and investigations. The Indian media's relentless pursuit of the next big story has resulted in intense scrutiny of governance practices in large Indian companies. This has raised awareness of the importance of good corporate governance among investors and furthered the cause of reform.

However, if improvements in India's corporate governance environment are to be realized, it is important that the government improve infrastructure as it relates to surveillance and enforcement mechanisms and the court system. Like most developing economies, India suffers from corruption, which increases the cost of doing business. The government needs to tackle this fundamental problem if long-term improvements are to be made.

For corporate governance-related improvements to percolate faster throughout Indian companies, the pace of reform needs to be increased. The Task Force recommends that the following specific actions be taken:

- Strengthen Clause 49 by giving SEBI and stock exchanges the authority to take action against errant companies (besides de-listing) by substantially increasing the cost of non-compliance.
- Increase shareholder activism in the country by creating a class of institutional investors who can take up corporate governance-related causes as significant shareholders. This can be achieved by speeding up currently stalled pension reforms.
- Improve surveillance mechanisms by adding manpower and training existing staff in the surveillance function at the stock exchange and regulatory authority level to carry out more compliance audits.
- Streamline the regulatory structure to reduce dilution of surveillance responsibility.
- Improve corporate governance-related reporting by companies to include back-up information to explain compliance with key requirements of Clause 49.
- Expedite the appointment of judges to the specialized courts created to handle corporate and finance-related cases.
- Improve framework to bring class-action lawsuits against errant companies.

INDIAN CORPORATE GOVERNANCE FRAMEWORK

India's legal framework for corporate governance is found in the Companies Act of 1956, most recently amended in 2002, and in Clause 49 of SEBI's requirements for listed companies. The analysis below compares the Companies Act and SEBI's listing requirements with the IIF Code.

Minority Shareholder Protection

The legal structure for corporate governance in India provides for strong minority shareholder protection compared with other emerging markets. Together, the Companies Act and SEBI's listing requirements account for most of the key minority shareholder protections that are found in the IIF Code.

Although the threshold limits at which minority shareholders can participate by calling special meetings and exercising other rights (usually 10 percent) is below the threshold suggested by the IIF code, in practice these thresholds cannot be reached as founder-promoters control many Indian companies. Non-founders' share ownership is dispersed. Therefore, the India Task Force finds that even though in theory India's legal framework provides for strong minority shareholder protection, in practice minority shareholders cannot always garner the strength to exercise their voting rights together.

Voting Rights

According to Indian rules and regulations, all shareholders have the right to participate and vote at general meetings. The IIF Code states that firms are encouraged to allow proxy voting and, as a best practice, proxy systems should be universally available to all shareholders. The Companies Act fulfills this provision of the IIF Code, granting all shareholders the legal right to appoint a proxy.

The IIF code states that each share should have one vote, and that the "one share, one vote" principle should be a threshold requirement for new issues. Until recently, laws in India complied with this rule. However, a rule enacted in 2001 by the Ministry of Company Affairs now permits Indian companies to issue shares with multiple voting rights or dividends as long as such shares do not exceed 25 percent of share capital and shareholders approve the issuance.

Indian law does not have specific provisions for cumulative voting, which the IIF Code states should be permitted. Provisions for cumulative voting, particularly in the election of directors, would be a means to foster stronger minority shareholder protection in India's legal framework for corporate governance.

Firm Capital Structure

The IIF Code recommends that firms require shareholder approval or board approval to change their capital structure through takeovers, mergers, division or spin-offs, capital increases,

dilution of voting and ownership rights, IPOs and significant share buybacks. Laws in India regarding a firm's capital structure meet and in some areas exceed the IIF Code's requirements. For example, in India, acquisition of more than 15 percent of shares or voting rights requires the acquirer to make a public offering, whereas the IIF Code requires a public offer when ownership exceeds 35 percent. To approve a merger, under SEBI's regulations a shareholder vote of 75 percent is required, as provided in the IIF Code.

According to the IIF Code, capital increases above a certain threshold should first be offered to existing shareholders. India's Companies Act complies by requiring that new capital issues first be offered to existing shareholders in proportion to their shares of paid-up capital. Only by a special resolution can this requirement be waived. This is intended as a minority shareholder protection mechanism.

Shareholder Meetings/Other Rights

India's legal framework complies with nearly all of the IIF Code's provisions for minority shareholder protection as it pertains to shareholder meetings. The Companies Act requires that an Annual General Meeting (AGM) be held every year, and that a notice convening the meeting be sent to all shareholders at least 21 days in advance of the meeting. In addition to the AGM, the Companies Act allows for shareholders controlling 10 percent of voting rights or paid-up capital to call a special or Extraordinary General Meeting (EGM), which complies with the IIF Code's provision.

India's legal provisions for quorum at the AGM may not sufficiently protect minority shareholders. The Companies Act only stipulates that 5 people must be present at the AGM to reach quorum, whereas the IIF Code recommends a quorum of around 30 percent of shareholders and suggests that some independent non-majority-owning shareholders should be present.

To help expedite minority shareholders' grievances, SEBI's Clause 49 stipulates that there must be a board-level shareholder grievance committee to address such disputes, and that a non-executive director must chair this committee. The introduction of grievance committees is one mechanism whereby shareholders can obtain redress outside of India's inefficient and corrupt court system.

Structure and Responsibilities of the Board of Directors

India's laws and regulations address nearly all of the key guidelines found in the IIF Code that pertain to boards of directors. Scope for improvement lies in requiring the creation of a board level nomination committee that would be responsible for identifying and recommending new directors. This would help curb the appointment of friends of founder/promoters or controlling shareholders as non-executive/independent directors.

Board Structure

The IIF Code provides a number of key guidelines relating to independent and non-executive directors. SEBI's Clause 49 includes a definition of board independence which complies with the IIF Code—that at least one-third of the board be non-executive and that a majority of these be independent. Clause 49 goes further to require that in cases where the chairman of the board is an executive, 50 percent of the board be comprised of independent directors.

Despite the requirement for board independence, the availability of trained independent directors in India is limited. Qualified directors are often willing to join only prestigious companies but shy away from joining the boards of smaller companies that could benefit the most from the guidance of independent directors. Recognizing the need for qualified independent directors, efforts are being made by organizations such as the Confederation of Indian Industries, the Federation of Indian Chambers of Commerce and Industry, and stock exchanges to train directors.

Board meetings

Clause 49 states that the board should meet at least four times a year, which complies with the IIF's provision for the frequency of meetings. The Indian rules and regulations for quorum at board meetings only partially comply with the IIF Code's provisions. The IIF Code provides that a board quorum should consist of executive, non-executive, and independent non-executive directors. The Companies Act, on the other hand, only requires that 33 percent of board members or two members, whichever is greater, be present. There is no provision that specifies whether non-executive or independent members need be present.

Nomination and election of directors

The Companies Act mandates that the directors of the Board be approved and appointed by the company in the Annual General Meeting. The IIF Code states that minority shareholders should have a mechanism for putting forward directors at both Annual General Meetings (AGM) and Extraordinary General Meetings (EGM). In India, founder/promoters or controlling shareholders generally appoint directors. There is limited scope for minority shareholders to recommend director nominees.

The IIF Code stipulates that there should be a board-level nomination committee and that it should be chaired by an independent director. Indian rules and regulations have no provisions mandating the creation of a board-level nomination committee.

Board committees

The IIF Code states that there should be at least three board committees: a nomination committee, a compensation committee, and an audit committee. In India, every board is required to have a shareholder grievance committee, as discussed above, and an audit committee. Creation of a separate remuneration committee is a non-mandatory requirement in Clause 49 of

the SEBI Code. In practice, however, boards of some large companies have an audit, remuneration and nomination committee.

Disclosure

The IIF Code provides that any material information that could affect share prices should be disclosed through the stock exchange, including the acquisition or disposal of substantial assets, board changes, related-party dealings, ownership changes, and directors' shareholdings. SEBI's Insider Trading Regulations, 2002, require every company to appoint a compliance officer who is responsible for setting policies, procedures, and monitoring adherence to the rules for the preservation of 'price sensitive information' to prevent insider trading. SEBI has established an insider trading committee to monitor this activity. The Task Force learned that insider trading is common in India, but difficult to detect. There is no good legal definition of insider trading, which hampers surveillance efforts.

Clause 49 also requires that listed companies begin disclosing their corporate governance practices in the Annual Report to shareholders. Moreover, companies are required to provide on their website information such as quarterly results and presentations made to analysts. Companies that do not have their own website have to send this information to the stock exchange on which they are listed so that the stock exchange can put it on its website.

Rules concerning disclosure of board member remuneration and conflicts of interest fully comply with the IIF Code. All fees and compensation paid to non-executive directors are fixed by the board of directors and require prior approval of shareholders in the Annual General Meeting.

Other responsibilities

Clause 49 requires listed companies to inform board members about risk assessments and risk minimization procedures in the company. The audit committee is also responsible for reviewing all related-party transactions and internal audit functions of the company.

The IIF code recommends that the governance framework require companies to have an investor relations program and to provide a policy statement concerning environmental issues and social responsibility. There are no such provisions in the Indian governance framework. However, in practice, some large Indian companies have social responsibility initiatives.

Accounting/Auditing

India's corporate governance framework agrees with most of the IIF guidelines in this area. However, requiring semi-annual audits as prescribed in the IIF Code and prohibiting the contemporaneous provision of audit and non-audit services from the same firm can further strengthen this area.

At present, under the non-mandatory requirement of Clause 49, Indian companies are encouraged to send half-yearly financial reports. Listed companies are required to provide quarterly compliance reports to regulatory authorities but the information provided in the half-yearly report and quarterly reports are not subject to full audit review.

Standards

The Institute of Chartered Accountants of India (ICAI) is an independent body regulating the accounting and auditing profession in India. The ICAI lays down the parameters of accounting and auditing standards in India and conducts professional examinations to certify accountants. Over the past two years the ICAI has revised a majority of India's Accounting Standards to comply with International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS). The ICAI is in the process of issuing/revising seven additional accounting standards in order to become fully compliant with all IAS and IFRS requirements.

The Companies Act requires shareholders to appoint an independent auditor at each Annual General Meeting. It also requires that the independent auditor be certified by the ICAI. Comprehensive audits are conducted annually in India.

Audit Committee

Revisions to Clause 49 incorporate several practices required by the Sarbanes-Oxley Act in the United States. Audit committees of listed Indian companies are now required to have a minimum of three directors as members, with at least two-thirds of the members being independent. In addition, at least one member of the audit committee should have accounting or related financial management expertise. Clause 49 also requires audit committees to review the adequacy of internal control systems.

Clause 49 does not prohibit the contemporaneous provision of audit and non-audit services from the same entity. It does, however, require the audit committee to fix audit fees and approve payments to auditors for other services provided.

Transparency of ownership and control

The Indian corporate governance framework meets most of the IIF Code's guidelines in this area. Improvements can be made by requiring disclosure of related-party transactions to shareholders. Currently, senior management is required to disclose potential conflicts of interest only to the Board. Given that most large Indian companies are family-controlled conglomerates, related-party transactions and related lending are a concern. Disclosure to shareholders in the Annual Report is needed. Clause 49 requires listed companies to disclose materially significant related-party transactions in the Report on Corporate Governance in the Annual Report to Shareholders, however, it does not define the term 'materially significant'.

Regulatory Environment

India’s regulatory framework meets most of the IIF’s guidelines in this area. Although SEBI, the capital markets regulator, is an independent body as required under the IIF Code, the weak enforcement mechanism in the country is a key concern for members of the India Task Force. Significant government action is needed to improve the enforcement and surveillance functions of regulators in India.

APPENDIX

Comparison of IIF Code
and
The Companies Act (CA) and the Securities and Exchange Board of India (SEBI) Listing Requirements

Issue	IIF Code	CA and SEBI
Minority shareholder protection		
Voting rights		
Proxy voting	Firms are encouraged to allow proxy voting.	Shareholders can appoint a proxy. A proxy can demand a poll and cast his vote but cannot speak at the meeting. The notice convening the meeting must state that shareholders can appoint a proxy.
One-share, one-vote principle	"One share, one vote" should be a threshold requirement for new issues.	All shares are equal within one class. Shares with different voting rights or dividend can be issued as long as shareholders approve the issue and such shares do not exceed 25% of total share capital. *(Companies Rule 2001 – issue of share capital with different voting rights or dividends)*
Cumulative voting	Cumulative voting should be permitted.	No provisions.
Capital structure		
Procedures on major corporate changes	Shareholder approval of mergers and major asset transactions should be required. If an offer is made above a reasonable minimum threshold of outstanding stock, a significant portion of that purchase must be through a public offer. Ownership exceeding 35% triggers a public offer in which all shareholders are treated equally. Under a merger or takeover, minority shareholders should have a legal right to sell shares at appraised value.	Mergers require a special resolution (more than 75% of shareholders present) at the shareholder meeting. In the event shareholders are not called upon to approve the merger, the acquirer has to make a public announcement of his/her intent to acquire the shares. *(Reg. 12 SEBI- Takeover Code)* Acquisition of 15% or more shares or voting rights of any company requires the acquirer to make a mandatory public offering. *(Reg. 10 SEBI – Takeover Code).* Exception: Compliance not mandatory when (i) acquirer already owns 15% or more but less than 75% of shares or voting rights of the company and in one year acquires less than 5% of shares or voting rights, (ii) acquirer already owns 75% of shares or voting rights of the company.
Capital increase (pre-emptive rights)	Shareholder approval is required. Any capital increase over a period of one year and above a minimum threshold must first be offered to all existing shareholders.	If a company is issuing further capital it is required to offer the shares to existing equity holders in proportion to the capital paid-up on those shares on that date. Notice for exercising the offer should be given at least 15 days prior to

Issue	IIF Code	CA and SEBI
		the issue. The offer can be transferred to another person unless the Articles of the company specifically disallow such transfer. Exception: (i) no preferential allotment if a special resolution to that effect has been passed in the Annual General Meeting, (ii) if a special resolution is not passed than the number of votes cast in favor of forfeiting preferential allotment should exceed votes against the forfeiture, and the Central Government should approve the application of the board of directors to waive requirement of preferential allotment. *(Sec. 81 of CA)*
Share buybacks	Details of share buybacks should be fully disclosed to shareholders.	A company can acquire its owns shares if (i) the buy-back is authorized by its Articles, (ii) a special resolution has been passed in the shareholders' meeting authorizing the buy-back, (iii) the buy-back is less than 25% of the total paid up capital and free reserves, (iv) the ratio of debt owed by the company is not more than twice the capital and its free reserves after the buy-back. (*Sec. 77A of CA*) Exception: A special shareholders resolution is not needed is the buy-back is less than 10% of the total paid-up equity capital and free reserves of the company and the buy-back has been authorized by the Board of Directors of the company.
Shareholder meeting/Other rights		
Meeting notice and agenda	Meeting notice and agenda should be sent to shareholders within a reasonable amount of time prior to meetings to prepare the proxy system and to be released publicly.	Companies are required to hold an Annual General Meeting (AGM) every year. *(Sec. 166 of CA)* Notice for such meeting should be sent to shareholders 21 days in advance. (*Sec. 171 of CA*)
Special meetings	Minority shareholders should be able to call special meetings with some minimum threshold of the outstanding shares.	Shareholder controlling 10% of voting rights or paid-up capital can call for a special or Extraordinary General Meeting (EGM). *(Sec. 169 of CA)*
Treatment of foreign shareholders	Foreign shareholders should be treated equally with domestic shareholders.	Foreign Institutional Investors (FIIs) must register with SEBI to participate in the market. Investments and returns are freely repatriable, except in the case of 22 specified items which attract the condition of dividend balancing and/or where the approval is subject to specific conditions such as lock in period on original investment, dividend cap, foreign exchanging neutrality, etc.

Issue	IIF Code	CA and SEBI
Conflicts between shareholders	Should have mechanisms whereby a majority of minority shareholders can trigger an arbitration procedure to resolve conflicts between minority and controlling shareholders.	Companies are required to create a 'Shareholders/Investors Grievance Committee' under the chairmanship of a non-executive director to look into the redressing of shareholder and investor complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. *(SEBI Code, Clause 49)*
Quorum	Should not be set too high or too low. Suggested level would be about 30% and should include some independent non-majority-owning shareholders. All key corporate decisions require a qualified quorum.	Quorum is set at five persons for a public company and two for other companies. *(Sec. 174 of CA)*
Structure and responsibilities of the Board of Directors		
Board structure		
Definition of independence	Cannot have a business or personal relationship with the management or company, and cannot be a controlling shareholder such that independence, or appearance of independence, is jeopardized.	An independent director is a non-executive director who: (i) aside from director's remuneration, does not have any material pecuniary relationship or transactions with the company, its promoters, management or subsidiaries which may affect the independence of judgment, (ii) is not related to the promoter or a person in management on the board or one level below the board, (iii) has not been an executive for the past three years, (iv) is not or has not been a partner in the past three years of a statutory or internal audit firm or a firm providing consulting services to the company, (v) is not a material supplier, service provider or customer or a lessor or lessee of the company which may affect independence of the director, (vi) is not a substantial (owning 2% or more of voting rights) shareholder of the company. *(SEBI Code, Clause 49)* All pecuniary relationship/transactions of non-executive directors should be disclosed in the annual report. *(SEBI Code, Clause 49)*
Share of independent directors	At least one-third of the board should be non-executive, a majority of whom should be independent.	The number of independent directors is dependent on whether the Chairman is an executive or non-executive director. In the case of a non-executive chairman, at least one-third of the board should be comprised of independent directors and in the case of an executive chairman, at least half of the board should be comprised of independent directors. *(SEBI Code, Clause 49)*

Issue	IIF Code	CA and SEBI
Frequency and record of meetings	For large companies, board meetings every quarter, audit committee meetings every 6 months. Minutes of meetings should become part of public record.	The Board shall meet at least four times a year, with a minimum time gap of three months between any two meetings. *(SEBI Code, Clause 49)*
Quorum	Should consist of executive, non-executive, and independent non-executive members.	Quorum for board meetings is 33% of total board strength or 2 members whichever is higher. *(Sec. 287 of CA)*
Nomination and election of directors	Should be done by a committee chaired by an independent director. Minority shareholders should have mechanism for putting forward directors at Annual General Meeting (AGM) and Extraordinary General Meeting (EGM).	No specific provision mandating the creation of a board-level nominating committee. The directors of the Board are appointed by the company in the Annual General Meeting. (*Sec. 255 of CA*) At the time of appointment of a new director or the re-appointment of a director, shareholders must be provided with a brief résumé of the director, nature of his expertise in specific functional areas and names of companies in which the person also holds other directorships. *(SEBI Code, Clause 49)*
Term limits for independent directors	For large companies, re-election should be every 3 years with specified term limits.	Unless the Articles of a Company provide for the retirement of all directors at every AGM, not less than one-third directors have to be appointed by the company at the AGM. (*Sec 255 of CA)*
Board committees	The Board should set up 3 essential committees: nomination, compensation and audit.	Every board is required to have an audit committee and a shareholder grievance committee. The board of directors is required to consider the CEO's remuneration. Creation of a separate remuneration committee is a non-mandatory requirement in Clause 49 of SEBI's listing requirements. In practice, however, most boards of large companies have an audit, remuneration and nomination committee.
Disclosure		
Disclosure of information that affects share prices	Any material information that could affect share prices should be disclosed through stock exchange. Material information includes acquisition/disposal of assets, board changes, related-party deals, ownership changes, directors' shareholdings, etc.	Every company is required to appoint a compliance officer who is responsible for setting policies, procedures, monitoring adherence to the rules for the preservation of 'price sensitive information' to prevent insider trading. *(SEBI Insider Trading Regulation, 2002)* There should be a separate section on Corporate Governance in the annual report to shareholders. Non-compliance with any mandatory requirements and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. *(SEBI Code, Clause 49)*

Issue	IIF Code	CA and SEBI
Procedures for information release	Through local exchanges, and as best practice, through company website.	Information such as quarterly results and presentations made by companies to analysts shall be put on the company's website, or shall be sent in such a form as to enable the stock exchange on which the company is listed to put it on its website. *(SEBI Code, Clause 49)*
Remuneration of directors	Should be disclosed in annual report. All major compensation schemes, including stock options, should be fully disclosed and subject to shareholder approval.	All fees/compensation paid to non-executive directors are fixed by the Board of Directors and require previous approval of shareholders in the Annual General Meeting. The shareholder's resolution should specify the limits for the maximum number of stock options that can be granted to non-executive directors in any financial year and in aggregate. *(SEBI Code, Clause 49)*
Other responsibilities		
Conflict of interest	Any potential or actual conflicts of interest on the part of directors should be disclosed. Head of audit committee should not have any such conflicts of interest. Board members should abstain from voting if they have a conflict of interest pertaining to that matter. Audit or ethics committee is required to review conflict-of-interest situations.	A company is required to disclose all bases for related-party transactions to the audit committee. It has to periodically provide a statement in summary form of transactions with related parties in the ordinary course of business, details of material individual transactions with related parties which are not in the normal course of business, and transactions with related parties or others that are not on an arms length basis with management's justification for such transactions. *(SEBI Code, Clause 49)* Disclosure of materially significant related-party transactions that may have potential conflicts with the interests of the company at large have to be made in the Report on Corporate Governance in the Annual Report to Shareholders. *(SEBI Code, Clause 49)*
Integrity of internal control and risk management system	Should be a function of the audit committee.	The company is required to lay down procedures to inform Board members about risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework. *(SEBI Code, Clause 49)* The audit committee also has to review the adequacy of the internal audit function, if any, including the structure of the internal audit department, staffing, seniority of the officials heading the department, reporting structure coverage, and frequency of internal audit. *(SEBI Code, Clause 49)*
Investor relations	Should have an investor relations program.	No specific provisions.

Issue	IIF Code	CA and SEBI
Social responsibility and ethics	Make a statement of policy concerning environmental issues and social responsibility.	No provisions.
Accounting/Auditing		
Standards		
National/international GAAP	Identify accounting standard used. Comply with local practices and use consolidated accounting (annually) for all subsidiaries in which sizable ownership exists.	India materially conforms to the International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA). *(ICAI and Companies Act)*
Frequency	Semi-annually audited report at end-FY.	Quarterly reports are subject to limited audit review. As part of the non-mandatory requirements, a half-yearly declaration of financial performance, including a summary of the significant events in the last six months, may be sent to each household of shareholders. *(SEBI Code, Clause 49)* Comprehensive audits are conducted annually.
Audit quality	Independent public accountant. As a best practice, auditors should adhere to the global standards devised by the International Forum on Accountancy Development (IFAD).	Every company at each AGM shall appoint an auditor(s) to hold office till the conclusion of the next AGM. *(Sec. 224 of CA)* The Companies Act requires annual accounts to be audited by an independent certified chartered accountant who is a member of the Institute of Chartered Accountants of India (ICAI). The quality of financial disclosures for listed companies is determined by the Department of Company Affairs, SEBI, and the ICAI. The ICAI lays down the parameters of accounting and auditing standards. The companies act requires management to explain and deviations from the prescribed accounting standards in financial statements.
Audit committee		
Audit committee	For large firms, must be chaired by qualified independent director with a financial background	The audit committee shall have minimum three directors as members, with two-thirds of the members being independent. *(SEBI Code, Clause 49)* All members of the audit committee should be financially literate and at least one member shall have accounting or related financial management expertise. *(SEBI Code, Clause 49)*

Issue	IIF Code	CA and SEBI
Relationship/communication with internal and external auditors	Committee should approve services provided by external auditor. Breakdown of proportion of fees paid for each service should be made available in annual report. As a best practice, communication with auditors should be without executives present. Contemporaneous provision of audit and non-audit services from the same entity should be prohibited.	The audit committee recommends to the board the appointment, re-appointment, and if required the replacement or removal of the external auditor and the fixation of audit fees. The committee also has to approve payment to auditors for other services provided. *(SEBI Code, Clause 49)* The audit committee has to review with management the performance of the external and internal audit firm and the adequacy of internal control systems. *(SEBI Code, Clause 49)*
Transparency of ownership and control		
Buyout offer to minority shareholders	As a best practice, ownership exceeding 35% triggers a buyout offer in which all shareholders are treated equally.	Acquisition of 15% or more shares or voting rights of any company requires the acquirer to make a mandatory public offering. *(Reg. 10 SEBI – Takeover Code).* <u>Exception</u>: Compliance not mandatory when (i) acquirer already owns 15% or more but less than 75% of shares or voting rights of the company and in one year acquires less than 5% of shares or voting rights, (ii) acquirer already owns 75% of shares or voting rights of the company.
Related-party ownership	Companies should disclose directors' and senior executives' shareholdings, and all insider dealings by directors and senior executives should be disclosed. Senior executives' and directors' share transactions should be disclosed within 3 days of execution.	Senior management is required to disclose potential conflicts of interest to the board. Directors are required to disclose share dealings beyond prescribed thresholds SEBI has issued rules against Insider trading. However, monitoring and prosecuting insider trading activity is very difficult
Minimally significant shareholders	Shareholders with minimally significant ownership (greater than 3-10%) of outstanding shares must disclose their holdings.	An acquirer, who acquires shares or voting rights exceeding specified threshold levels has to disclose at every stage the aggregate of his holdings or voting rights to the company and to the stock exchanges where the companies are listed. Current threshold limits are 5%, 10% or 14% of shares or voting rights *(Reg. 7 SEBI – Takeover Code)*
Regulatory environment		
Enforcement powers	The supervisory authority and the exchange must have adequate enforcement powers. Exchanges should have the power to grant, review, suspend, or terminate the listing of securities. Enforcement authorities should have adequate training and an understanding of the judicial process.	The Ministry of Company Affairs (MoCA), regulators like RBI and SEBI and stock exchanges have surveillance functions. MoCA has surveillance responsibility over unlisted. For listed companies, stock exchanges are considered to be the first line of defense followed by SEBI. RBI oversees companies in the banking and financial sector.

Issue	IIF Code	CA and SEBI
Independence of supervisory body and of exchange	The supervisory body and the exchange should be independent from government and industry.	SEBI is an independent quasi-judicial body that plays an active regulatory and development role in India's security market. The Central Government appoints the chairman and may nominate a maximum of nine other members. The body is funded by contributions from public financial and institutional institutions, banks and the Government of India.

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