

DESIRABLE CORPORATE GOVERNANCE

A CODE



Confederation of Indian Industry
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FOREWORD

In 1996, CII took a special initiative on Corporate Governance – the first institutional initiative in Indian industry. The objective was to develop and promote a code for Corporate Governance to be adopted and followed by Indian companies, be these in the Private Sector, the Public Sector, Banks or Financial Institutions, all of which are corporate entities.

This initiative by CII flowed from public concerns regarding the protection of investor interest, especially the small investor; the promotion of transparency within business and industry; the need to move towards international standards in terms of disclosure of information by the corporate sector and, through all of this, to develop a high level of public confidence in business and industry.

A National Task Force set up with Mr. Rahul Bajaj , Past President ,CII and Chairman & Managing Director, Bajaj Auto Limited, as the Chairman included membership from industry, the legal profession, media and academia.

This Task Force presented the draft guidelines and the code of Corporate Governance in April 1997 at the National Conference and Annual Session of CII. This draft was then publicly debated in workshops and Seminars and a number of suggestions were received for the consideration of the Task Force.

Reviewing, these suggestions, and the development, which have taken, place in India and abroad over the past year, the Task Force has finalised the Desirable Corporate Governance Code. CII has the pleasure in presenting this Code in this document for information, for understanding and for implementation of Indian business and industry.

CII would like to acknowledge, with deep gratitude, the role and leadership provided by the Task Force Chairman, Mr. Rahul Bajaj, and the economist in the group, Dr. Omkar Goswami, who undertook a great deal of research and too special responsibility for drafting the Code.

Since 1974, CII has tried to chart new path in terms of the role of an Industry Association such as itself. It has gone beyond dealing with the traditional work of interacting with Government of policies & procedures, which impact on industry. CII has taken initiatives in Quality, Environment, Energy, Trade Fairs, Social Development, International Partnership Building, etc. as part of its process of development and expanding contribution to issues of relevance and concern to industry.

This Code of Corporate Governance continues this process and takes it one step further. Fortunately there is very little difference between the draft Code released in April 1997 and the final Code, which is now published. It reflects the comprehensiveness of the Task Force's work and the thought, which has gone into preparing this Code. Its is pioneering work , it is path-breaking initiative and we are delighted to release the Code in the hope that the corporate sector will implement it seriously and sincerely.

April 1998

N Kumar
President, CII

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Although “corporate governance” still remains an ambiguous and misunderstood phrase, three aspects are becoming evident.

- First, there is no unique structure of “corporate governance” in the developed world; nor is one particular type unambiguously better than others. Thus, one cannot design a code of corporate governance for Indian companies by mechanically importing one form or another.
- Second, Indian companies, banks and financial institutions (FIs) can no longer afford to ignore better corporate practices. As India gets integrated in the world market, Indian as well as international investors will demand greater disclosure, more transparent explanation for major decisions and better shareholder value.
- Third, corporate governance goes far beyond company law. The quantity, quality and frequency of financial and managerial disclosure, the extent to which the board of directors exercise their fiduciary responsibilities towards shareholders, the quality of information that management share with their boards, and the commitment to run transparent companies that maximise long term shareholder value cannot be legislated at any level of detail. Instead, these evolve due to the catalytic role played by the more progressive elements within the corporate sector and, thus, enhance corporate transparency and responsibility.

A Minimal Definition

Corporate governance deals with laws, procedures, practices and implicit rules that determine a company’s ability to take managerial decisions *vis-à-vis* its claimants—in particular, its shareholders, creditors, customers, the State and employees. There is a global consensus about the objective of ‘good’ cor-

porate governance: *maximising long term shareholder value*. Since shareholders are residual claimants, this objective follows from a premise that, in well performing capital and financial markets, whatever maximises shareholder value must necessarily maximise corporate prosperity, and best satisfy the claims of creditors, employees, shareholders, and the State.

For a corporate governance code to have real meaning, it must first focus on *listed companies*. These are financed largely by public money (be it equity or debt) and, hence, need to follow codes and policies that make them more accountable and value-oriented to their investing public. There is a diversity of opinion regarding beneficiaries of corporate governance. The Anglo-American system tends to focus on shareholders and various classes of creditors. Continental Europe, Japan and South Korea believe that companies should also discharge their obligations towards employees, local communities, suppliers, ancillary units, and so on. In the first instance, *it is useful to limit the claimants to shareholders and various types of creditors*. There are two reasons for this preference.

1. The corpus of Indian labour laws are strong enough to protect the interest of workers in the organised sector, and employees as well as trade unions are well aware of their legal rights. In contrast, there is very little in terms of the implementation of law and of corporate practices that protects the rights of creditors and shareholders
2. There is much to recommend in law, procedures and practices to make companies more attuned to the needs of properly servicing debt and equity. If most companies in India appreciate the importance of creditors and shareholders, then we will have come a long way.

Irrespective of differences between various forms of corporate governance, all recognise that good corporate practices must—at the very least—satisfy two sets of claimants: creditors and shareholders. In the developed world, company managers must perform to satisfy creditors' dues because of the *disciplining device of debt, which carries with it the credible threat of management change via bankruptcy*. Analogously, managers have to look after the right of shareholders to dividends and capital gains because if they do not do so over time, they face the real *risk of take-over. An economic and legal environment that puts a brake on the threat of bankruptcy and prevents take-overs is a recipe for systematic corporate mis-governance.*

Board of Directors

The key to good corporate governance is a well functioning, informed board of directors. The board should have a core group of excellent, professionally acclaimed non-executive directors who understand their dual role: of appreciating the issues put forward by management, and of honestly discharging their fiduciary responsibilities towards the company's shareholders as well as creditors.

Recommendation 1

There is no need to adopt the German system of two-tier boards to ensure desirable corporate governance. A single board, if it performs well, can maximise long term shareholder value just as well as a two- or multi-tiered board. Equally, there is nothing to suggest that a two-tier board, per se, is the panacea to all corporate problems.

However, the full board should meet a minimum of six times a year, preferably at an interval of two months, and each meeting should have agenda items that require at least half a day's discussion.

It has been proved time and again in the USA, Great Britain, Germany and many other OECD countries that the quality of the board—and, hence, corpo-

rate governance—improves with the induction of outside professionals as non-executive directors. As a recent article put it:

Obviously not all well governed companies do well in the market place. Nor do the badly governed ones always sink. But even the best performers risk stumbling some day if they lack strong and independent boards of directors.

Business Week, November 25, 1996. 84

Securing the services of good, professionally competent, independent non-executive directors does not necessarily require the institutionalising of nomination committees or search committees. However, it does require a code that specifies a minimal thumb-rule. This leads to the second recommendation.

Recommendation 2

Any listed companies with a turnover of Rs.100 crores and above should have professionally competent, independent, non-executive directors, who should constitute

- **at least 30 percent of the board if the Chairman of the company is a non-executive director, or**
- **at least 50 percent of the board if the Chairman and Managing Director is the same person.**

Getting the right type of professionals on the board is only one way of ensuring diligence. It has to be buttressed by the concept of limitation: one cannot hold non-executive directorships in a plethora of companies, and yet be expected to discharge one's obligations and duties. This yields the third recommendation.

Recommendation 3

No single person should hold directorships in more than 10 listed companies.

As of now, section 275 of the Companies Act allows a person to hold up to 20 directorships. The *Report of the Working Group on the Companies*

Act (February 1997) has kept the number unchanged. It is felt that with 20 directorships it would be extremely difficult for an individual to make an effective contribution and ensure good governance, and yet discharge his fiduciary responsibilities towards all.

In this context, it is useful to give the trend in the USA. According to a recent survey of over 1,000 directors and chairmen of US corporations, the directors themselves felt that no one should serve on more than an average of 2.6 Boards. On 12 November 1996, a special panel of 30 corporate governance experts co-opted by the National Association of Corporate Directors of the USA recommended that Senior executives should sit on no more than 3 boards, including their own. Retired executives and professional non-executive directors should serve on no more than 6.

Recommendation 4

For non-executive directors to play a material role in corporate decision making and maximising long term shareholder value, they need to

- **become active participants in boards, not passive advisors;**
- **have clearly defined responsibilities within the board such as the Audit Committee; and**
- **know how to read a balance sheet, profit and loss account, cash flow statements and financial ratios and have some knowledge of various company laws. This, of course, excludes those who are invited to join boards as experts in other fields such as science and technology.**

This brings one to remuneration of non-executive directors. At present, most non-executive directors receive a sitting fee which cannot exceed Rs.2,000 per meeting. The Working Group on the Companies Act has recommended that this limit should be raised to Rs.5,000. Although this is better than Rs.2,000, it is hardly sufficient to induce serious effort by the non-executive directors.

Recommendation 5

To secure better effort from non-executive directors, companies should:

- **Pay a commission over and above the sitting fees for the use of the professional inputs. The present commission of 1% of net profits (if the company has a managing director), or 3% (if there is no managing director) is sufficient.**
- **Consider offering stock options, so as to relate rewards to performance. Commissions are rewards on current profits. Stock options are rewards contingent upon future appreciation of corporate value. An appropriate mix of the two can align a non-executive director towards keeping an eye on short term profits as well as longer term shareholder value.**

The above recommendation can be easily achieved without the necessity of any formalised remuneration committee of the board. To ensure that non-executive directors properly discharge their fiduciary obligations, it is, however, necessary to give a record of their attendance to the shareholders.

Recommendation 6

While re-appointing members of the board, companies should give the attendance record of the concerned directors. If a director has not been present (absent with or without leave) for 50 percent or more meetings, then this should be explicitly stated in the resolution that is put to vote. As a general practice, one should not re-appoint any director who has not had the time attend even one half of the meetings.

It is important to recognise that, under usual circumstances, non-executive directors in India suffer from lack of quality information. Simply put, the extent to which non-executive directors can play their role is determined by the quality of disclosures that are made by the management to the board. In the interest of good governance, certain key information must be placed before the board, and must form part of the agenda papers.

Recommendation 7

Key information that must be reported to, and placed before, the board must contain:

- Annual operating plans and budgets, together with up-dated long term plans.
- Capital budgets, manpower and overhead budgets.
- Quarterly results for the company as a whole and its operating divisions or business segments.
- Internal audit reports, including cases of theft and dishonesty of a material nature.
- Show cause, demand and prosecution notices received from revenue authorities which are considered to be materially important. (Material nature is any exposure that exceeds 1 percent of the company's net worth).
- Fatal or serious accidents, dangerous occurrences, and any effluent or pollution problems.
- Default in payment of interest or non-payment of the principal on any public deposit, and/or to any secured creditor or financial institution.
- Defaults such as non-payment of inter-corporate deposits by or to the company, or materially substantial non-payment for goods sold by the company.
- Any issue which involves possible public or product liability claims of a substantial nature, including any judgement or order which may have either passed strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company.
- Details of any joint venture or collaboration agreement.
- Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
- Recruitment and remuneration of senior officers just below the board level, including appointment or removal of the Chief Financial Officer and the Company Secretary.
- Labour problems and their proposed solutions.

- Quarterly details of foreign exchange exposure and the steps taken by management to limit the risks of adverse exchange rate movement, if material.

The Report of the Working Group on the Companies Act was in favour of Audit Committees, but recommended that these be set up voluntarily “with the industry associations playing a catalytic role” [p.23]. The Group felt that legislating in favour of Audit Committees would be counter-productive, and could lead to a situation where such committees would be often constituted to meet the letter—and not the spirit—of the law. Nevertheless, there is a clear need for Audit Committees, which yields the next recommendation.

Recommendation 8

1. Listed companies with either a turnover of over Rs.100 crores or a paid-up capital of Rs.20 crores should set up Audit Committees within two years.
2. Audit Committees should consist of at least three members, all drawn from a company's non-executive directors, who should have adequate knowledge of finance, accounts and basic elements of company law.
3. To be effective, the Audit Committees should have clearly defined Terms of Reference and its members must be willing to spend more time on the company's work vis-à-vis other non-executive directors.
4. Audit Committees should assist the board in fulfilling its functions relating to corporate accounting and reporting practices, financial and accounting controls, and financial statements and proposals that accompany the public issue of any security—and thus provide effective supervision of the financial reporting process.
5. Audit Committees should periodically interact with the statutory auditors and the internal auditors to ascertain the quality and veracity of the company's accounts as well as the capability of the auditors themselves.

6. **For Audit Committees to discharge their fiduciary responsibilities with due diligence, it must be incumbent upon management to ensure that members of the committee have full access to financial data of the company, its subsidiary and associated companies, including data on contingent liabilities, debt exposure, current liabilities, loans and investments.**
7. **By the fiscal year 1998-99, listed companies satisfying criterion (1) should have in place a strong internal audit department, or an external auditor to do internal audits; without this, any Audit Committee will be toothless.**

Why should the management of most Indian companies bother about giving such information to their Audit Committees? The answer is straightforward. Over time, they will have to, for there will be a clear-cut signalling effect. Better companies will choose professional non-executive directors and form independent Audit Committees. Others will either have to follow suit, or get branded as the corporate laggards. Moreover, once there is an established correlation between Audit Committees on the one hand, and the quality of financial disclosure on the other, investors will vote with their feet. The last two years have seen domestic investors escape from equity in favour of debt, particularly bonds issued by public financial institutions. If the corporate sector wants to create a comeback for equity, it can only do so through greater transparency. Audit Committees ensure long term goodwill through such transparency.

Desirable Disclosure

Our corporate disclosure norms are inadequate. With the growth of the financial press and equity researchers, the days of having opaque accounting standards and disclosures are rapidly coming to an end. As a country which wishes to be a global player, we cannot hope to tap the GDR market with inadequate financial disclosures; it will not be credible to present

one set of accounts to investors in New York and Washington DC, and a completely different one to the shareholders in Mumbai and Chennai. So, what is the minimum level of disclosure that Indian companies ought to be aiming for?

The *Working Group on the Companies Act* have recommended many financial as well as non-financial disclosures. It is worth recapitulating the more important ones.

Non-Financial disclosures recommended by the Working Group on the Companies Act

1. Comprehensive report on the relatives of directors—either as employees or Board members—to be an integral part of the Directors' Report of all listed companies.
2. Companies have to maintain a register which discloses interests of directors in any contract or arrangement of the company. The existence of such a register and the fact that it is open for inspection by any shareholder of the company should be explicitly stated in the notice of the AGM of all listed companies.
3. Similarly, the existence of the directors' shareholding register and the fact that it can be inspected by members in any AGM should be explicitly stated in the notice of the AGM of all listed companies.
4. Details of loans to directors should be disclosed as an annex to the Directors' Report in addition to being a part of the schedules of the financial statements. Such loans should be limited to only three categories—housing, medical assistance, and education for family members—and be available only to full time directors. The detailed terms of loan would need shareholders approval in a general meeting.
5. Appointment of sole selling agents for India will require prior approval of a special resolution in a general meeting of shareholders. The board may

approve the appointment of sole selling agents in foreign markets, but the information must be divulged to shareholders as a part of the Directors' Report accompanying the annual audited accounts. In either case, if the sole selling agent is related to any director or director having interest, this fact has to not only be stated in the special resolution but also divulged as a separate item in the Directors' Report.

6. Subject to certain exceptions, there should be a Secretarial Compliance Certificate forming a part of the Annual Returns that is filed with the Registrar of Companies which would certify, in prescribed format, that the secretarial requirements under the Companies Act have been adhered to.

Financial disclosures recommended by the Working Group on the Companies Act

1. A tabular form containing details of each director's remuneration and commission should form a part of the Directors' Report, in addition to the usual practice of having it as a note to the profit and loss account.
2. Costs incurred, if any, in using the services of a Group Resource Company must be clearly and separately disclosed in the financial statement of the user company.
3. A listed company must give certain key information on its divisions or business segments as a part of the Directors' Report in the Annual Report. This should encompass (i) the share in total turnover, (ii) review of operations during the year in question, (iii) market conditions, and (iv) future prospects. For the present, the cut-off may be 10% of total turnover.
4. Where a company has raised funds from the public by issuing shares, debentures or other securities, it would have to give a separate statement showing the end-use of such funds, namely: how much was raised versus the stated and actual

project cost; how much has been utilised in the project up to the end of the financial year; and where are the residual funds, if any, invested and in what form. This disclosure would be in the balance sheet of the company as a separate note forming a part of accounts.

5. The disclosure on debt exposure of the company should be strengthened.
6. In addition to the present level of disclosure on foreign exchange earnings and outflow, there should also be a note containing separate data on of foreign currency transactions that are germane in today's context: (i) foreign holding in the share capital of the company, and (ii) loans, debentures, or other securities raised by the company in foreign exchange.
7. The difference between financial statements pertaining to fixed assets and long term liabilities (including share capital and liabilities which are not to be liquidated within a year) as at the end of the financial year and the date on which the board approves the balance sheet and profit and loss account should be disclosed..
8. If any fixed asset acquired through or given out on lease is not reported under appropriate sub-heads, then full disclosure would need to be made as a note to the balance sheet. This should give details of the type of asset, its total value, and the future obligations of the company under the lease agreement.
9. Any inappropriate treatment of an item in the balance sheet or profit and loss account should not be allowed to be explained away either through disclosure of accounting policies or via notes forming a part of accounts but should be dealt with in the Directors' Report.

While the disclosures recommended by the Working Group in its report as well as in the modified Schedule VI that would accompany the Draft Bill go far

beyond existing levels, much more needs to be done outside the framework of law, particularly (i) a model of voluntary disclosure in the current context, and (ii) consolidation of accounts.

All other things being equal, greater the quality of disclosure, the more loyal are a company's shareholders. Besides, there is something very inequitable about of present disclosure standards: we have one norm for the foreigners when we go in for GDRs or private placement with foreign portfolio investors, and a very different one for our more loyal Indian shareholders. This should not continue. The suggestions given below partly rectify this imbalance.

Recommendation 9

Under "Additional Shareholder's Information", listed companies should give data on:

- 1. High and low monthly averages of share prices in a major Stock Exchange where the company is listed for the reporting year.**
- 2. Greater detail on business segments up to 10% of turnover, giving share in sales revenue, review of operations, analysis of markets and future prospects.**

The Working Group on the Companies Act has recommended that consolidation should be optional, not mandatory. There were two reasons: (i) first, that the Income Tax Department does not accept the concept of group accounts for tax purposes—and the *Report of the Working Group on the Income Tax Act* does not suggest any difference, and (ii) the public sector term lending institutions do not allow leveraging on the basis of group assets. Thus:

Recommendation 10

- 1. Consolidation of Group Accounts should be optional and subject to**
 - the FIs allowing companies to leverage on the basis of the group's assets, and**
 - the Income Tax Department using the group concept in assessing corporate income tax.**

- 2. If a company chooses to voluntarily consolidate, it should not be necessary to annex the accounts of its subsidiary companies under section 212 of the Companies Act.**
- 3. However, if a company consolidates, then the definition of "group" should include the parent company and its subsidiaries (where the reporting company owns over 50% of the voting stake).**

One of the most appealing features of the *Cadbury Committee Report (Committee on the Financial Aspects of Corporate Governance)* is the Compliance Certificate that has to accompany the annual reports of all companies listed in the London Stock Exchange. This alone has created a far more healthy milieu for corporate governance despite the cosy, club-like atmosphere of British boardrooms. It is essential that a variant of this be adopted in India.

Recommendation 11

Major Indian stock exchanges should gradually insist upon a compliance certificate, signed by the CEO and the CFO, which clearly states that:

- The management is responsible for the preparation, integrity and fair presentation of the financial statements and other information in the Annual Report, and which also suggest that the company will continue in business in the course of the following year.**
- The accounting policies and principles conform to standard practice, and where they do not, full disclosure has been made of any material departures.**
- The board has overseen the company's system of internal accounting and administrative controls systems either director or through its Audit Committee (for companies with a turnover of Rs.100 crores or paid-up capital of Rs.20 crores)**

As mentioned earlier, there is something inequitable about disclosure by a company substantially more for its GDR issue as compared to its domestic issue. This treats Indian shareholders as if they are children of a lesser God.

Recommendation 12

For all companies with paid-up capital of Rs. 20 crores or more, the quality and quantity of disclosure that accompanies a GDR issue should be the norm for any domestic issue.

Capital Market Issues

Since “take-over” is immediately associated with “raider”, it is considered an unethical act of corporate hostility. The bulk of historical evidence shows otherwise. Growth of industry and business in most developed economies have been aided and accompanied by take-overs, mergers and strategic acquisitions.

International data shows that take-overs usually serve three purposes: (i) creates economies of scale and scope, (ii) imposes a credible threat on management to perform for the shareholders, and (iii) enhances shareholder value in the short- and in the medium-term. Because the targets are typically under-performing companies, take-overs typically enhance short- as well as longer term shareholder value. The short term value rises because the bidder has to offer shareholders a price that is significantly higher than the market. Longer term gains tend to occur because the buyer has not only bet on generating higher value through cost cutting, eliminating unproductive lines and strengthening productive ones but also put in his money to own the controlling block of equity.

The new Take-over Code has been introduced in India. Although the code has its problems—especially after a 50 percent acquisition—it is a step in the right direction. However, the code is, at best, necessary for facilitating take-overs; it is hardly sufficient. There lies the basic problem with take-overs in India. *One cannot have a dynamic market and a level playing field for take-overs when there are multiple restrictions on financing such acquisitions.*

- *Banks do not lend for such activities. Until the slack season credit policy announced on 15 April*

1997, banks had imposed a credit limit is Rs.10 lakhs against share collateral—hardly the kind of money that can fund domestically financed take-overs.

- *There is no securitisation.* This prevents the value of underlying assets to be used in refinancing—something which could not only reduce cost of funds but also facilitate take-overs by dynamic but not necessarily cash rich entrepreneurs.
- *FIs do not finance take-overs.*
- *There are not enough corporate debt instruments which a company could use to finance a take-over—and even these attract very high rates of Stamp Duty.*

In such an environment, it is not surprising that one ends up with a severely limited take-over code where an acquirer can go into take-over mode and, yet need not increase its equity exposure to more than 30 percent. Moreover, it queers the pitch in favour of those who have access to off-shore funds, which do not operate under these artificial constraints. As things stand, there will be only two types of raiders: (i) entrepreneurs from cash rich industries, and (ii) foreign investors who can garner substantial cheap funds from abroad. From a perspective of industrial growth—where take-overs become vehicles for synergy, scale, new technological and managerial inputs, corporate dynamism, and long term enhancement of shareholder value—it is essential that dynamic Indian firms and entrepreneurial groups attempting take-overs be treated the same way by Indian banks and FIs as their buyout counterparts are in the west. This leads to an important recommendation.

Recommendation 13

Government must allow far greater funding to the corporate sector against the security of shares and other paper.

When this is in place, the take-over code should be modified to reflect international norms. Once

take-over finance is easily available to Indian entrepreneurs, the trigger should increase to 20%, and the minimum bid should reflect *at least* a 51% take-over.

Creditors' Rights

It is a universal axiom that creditors have a prior and pre-committed claim on the income of the company, and that this claim has to be satisfied irrespective of the state of affairs of the company. Important creditors can, and do, demand periodic operational information to monitor the state of health of their debtor firms; but, so long as their dues are being repaid (and expected to be repaid) on schedule, pure creditors have no legal say in the running of a company. *Therefore, insofar as creditors are not shareholders, and so long as their dues are being paid in time, they should desist from demanding a seat on the board of directors.*

This is an important point in the Indian context. Almost all term loans from FIs carry a covenant that it will be represented on the board of the debtor company via a nominee director. This yields the next recommendation.

Recommendation 14

It would be desirable for FIs as pure creditors to re-write their covenants to eliminate having nominee directors except:

- a) **in the event of serious and systematic debt default; and**
- b) **in case of the debtor company not providing six-monthly or quarterly operational data to the concerned FI(s).**

Today, credit-rating is compulsory for any corporate debt issue. But, as in the case of primary equity issues, the quality of information given to the Indian investing public is still well below what is disclosed in many other developed countries. Given below are some suggestions.

Recommendation 15

1. **If any company goes to more than one credit rating agency, then it must divulge in the prospectus and issue document the rating of all the agencies that did such an exercise.**
2. **It is not enough to state the ratings. These must be given in a tabular format that shows where the company stands relative to higher and lower ranking. It makes considerable difference to an investor to know whether the rating agency or agencies placed the company in the top slots, or in the middle, or in the bottom.**
3. **It is essential that we look at the quantity and quality of disclosures that accompany the issue of company bonds, debentures, and fixed deposits in the USA and Britain—if only to learn what more can be done to inspire confidence and create an environment of transparency.**
4. **Finally, companies which are making foreign debt issues cannot have a two sets of disclosure norms: an exhaustive one for the foreigners, and a relatively minuscule one for Indian investors.**

There is another area of concern regarding creditors' rights. This has to do with holders of company deposits. In the last three years, there have been too many instances where manufacturing as well as investment and finance companies have reneged on payment of interest on company deposits or repayment of the principal. Since these deposits are generally unsecured loans, the deposit holders are prime targets of default.

Recommendation 16

Companies that default on fixed deposits should not be permitted to

- **accept further deposits and make inter-corporate loans or investments until the default is made good; and**
- **declare dividends until the default is made good.**

On FIs and Nominee Directors

Consider two facts: (i) the largest debt-holders of private sector corporate India are public sector term lending institutions such as IDBI, IFCI, and ICICI; and (ii) these institutions are also substantial shareholders and, like in Germany, Japan and Korea, sit on the boards as nominee directors. So, in effect they have combined inside debt-cum-equity positions so common to German, Japanese and Korean forms of corporate governance. But these informed insiders in India do not seem to behave like their German counterparts; corporate governance and careful monitoring do not happen as they are supposed to when a stake-holder is both creditor and owner of equity, as in Germany.

The apparent failure of government controlled FIs to monitor companies in their dual capacity as major creditors and shareholders has much to do with a pervasive anti-incentive structure. There are several dimensions of this structure. First, major decisions by public sector financial institutions are eventually decided by the Ministry of Finance, and not by their board of directors. De jure, this cannot be cause for complaint—after all the Government of India is the major shareholder and, hence, has the right to call the shots. However, at issue is the manner in which the government calls the shots, and whether its decisions enhance shareholder value for the FIs. Second, nominee directors of FIs have no personal incentive to monitor their companies. They are neither rewarded for good monitoring nor punished for non-performance. Third, there is a tradition of FIs to supporting existing management except in the direst of circumstances. Stability of existing management is not necessarily a virtue by itself, unless it translates to greater transparency and higher shareholder value. Fourth, compared to the number of companies where they are represented on the board, the FIs simply do not have enough senior-level personnel who can properly discharge their obligations as good corporate governors. In a

nutshell, therefore, while nominee directors of FIs ought to be far more powerful than the disinterested non-executive directors, they are in fact at par. Consequently, the institutions which could have played the most proactive role in corporate governance—India's largest concentrated shareholders-cum-debt-holders—have not done so.

The long term solution requires questioning the very basis of majority government ownership of the FIs, and whether it augurs for better governance and higher shareholder value for India's companies as well as the FIs themselves. As a rule, government institutions are not sufficiently concerned about adverse income and wealth consequences arising out of wrong decisions and inaction; their incentive structures do not reward performance and punish non-performance; and, most of all, they remain highly susceptible to pulls and pressures from various ministries which have little to do with commercial accountability, and which often destroy the bottom-line. Therefore, it is necessary to debate whether the government should gradually become a minority shareholder in all its financial sector institutions. This debate needs to be thrown open to taxpayers and the investing public. But, for the present, there is a short term solution that must be considered as quickly as possible.

Recommendation 17

Reduction in the number of companies where there are nominee directors. It has been argued by FIs that there are too many companies where they are on the board, and too few competent officers to do the task properly. So, in the first instance, FIs should take a policy decision to withdraw from boards of companies where their individual shareholding is 5 percent or less, or total FI holding is under 10 percent.

Concluding Remarks

A code of corporate governance cannot be static. It must be reviewed. Therefore, *CII must review this*

report after some time, preferably within the next five years. Having said this, the report focuses on two more issues: (i) What does one mean by a “code” of corporate governance? (ii) A vision of things to come in the next few years, and its implications for corporate governance.

Simply put, corporate governance refers to *an economic, legal and institutional environment* that allows companies diversify, grow, restructure and exit, and do everything necessary to maximise long term shareholder value. Thus, non-executive directors and disclosures are parts, and not the whole, of corporate governance. To most international experts on the subject, corporate governance is an interplay between companies, shareholders, creditors, capital markets, financial sector institutions and company law. Hence, a code of corporate governance must attempt to address all these issues. This report, therefore, does constitute a code of corporate governance; and it consciously goes beyond the duty of boards and non-executive directors. Moreover, this code of corporate governance—despite its possible lacunae—will not become a reality with a stroke of a magic wand. It is a fairly substantive and radical code; it will therefore have its detractors; and putting it into effect will be a long haul.

Nevertheless, it is vital for the corporate well being of India. To appreciate this, it is useful to take a peep at the vision of the near future. It is a vision that will almost certainly come to bear, and shall, willy-nilly, shape tomorrow’s corporate governance.

1. First, a larger number of foreign portfolio investors will constantly raise their demand for better corporate governance, more transparency and greater disclosure. This is precisely what happened in the US from the early 1980s and in Britain since the early 1990s.
2. Second, in a year or at most two there will be the entry of foreign pension funds. Since these funds tend to hold on to their stocks longer than mutual funds, their fund managers will be even more active in insisting upon better corporate governance.
3. Third, in the foreseeable future, there could conceivably be, at least half a dozen private equity or leveraged buy-out funds, each with an investment base of US\$50 million or more. These funds will take a two to three year view on under-performing but asset rich Indian companies, take them over, de-list for a couple of years, and then return to the market to exit from their portfolio after successful turnaround. Thus, Indian companies will become targets for take-over. The target becomes all the more attractive if management has not given long term shareholder value.
4. Fourth, Indian FIs will not continue to support management irrespective of performance. Therefore, one will see FIs converting their outstanding debt to equity, and setting up mergers and acquisition subsidiaries to sell their shares in under-performing companies to more dynamic entrepreneurs and managerial groups.
5. Fifth, even if FIs do not have M&A wings, they will still unintentionally queer the pitch for equity. So long as IDBI, ICICI and IFCI have maturity mismatch between their assets and liabilities, they will in all probability, periodically come to the market for raising resources with high yield instruments like 15% to 16% bonds. Such a high yield on what is effectively a risk-free instrument will put an upper bound to the demand for relatively more risky equity. This is expected to continue for a few years. It implies that Indian companies will have to rely much more on GDRs, other ECBs and private placement—all of which will necessarily require more transparency and disclosure and better governance.
6. Sixth, the financial press will get stronger than ever before. In the last five years, the press and financial analysts have induced a level of disclo-

sure that was inconceivable a decade ago. This will increase and force companies to become more transparent—not just in their financial statements but also in matters relating to internal governance.

7. Finally, when India has full capital account convertibility, an Indian investor who has money to invest would have the option of investing either in an Indian or a foreign company. The investor would be inclined to invest in the Indian company if it follows, some standards of transparency, disclosure and corporate governance.

What does all this mean for better corporate governance? Everything. The loyalty of a typical

Indian investor is far greater than his counterparts in the USA or Britain. But, our companies must not make the mistake of taking such loyalty as a given. To nurture and strengthen this loyalty, our companies need to give a clear-cut signal that the words “your company” has real meaning. That requires well functioning boards, greater disclosure, better management practices, and a more open, interactive and dynamic corporate governance environment. Quite simply, shareholders’ and creditors’ support are vital for the survival, growth and competitiveness of India’s companies. Such support requires us to tone up our act today.