CHAPTER III
INDIAN CORPORATE GOVERNANCE PRACTICES

3.1 Introduction
3.2 History of Indian Companies
3.3 Growth of Indian Corporate Sector
3.4 Corporate Governance In India
3.5 Profile of Indian Business
3.6 Reasons for the Poor Governance Practices
3.7 Changing Scenario
3.8 Government and Corporate Governance
3.9 Securities Exchange Board of India
3.10 Conclusion
3.1 INTRODUCTION

The company form of organisation in India is the gift of British Empire. This chapter makes an attempt to trace the evolution and growth of companies in India. The profile of Indian business is attempted to be projected. The present researcher attempts to highlight the issue of corporate governance with reference to Indian companies. If the analysis reveals any pitfalls in the corporate governance system in India, the researcher aims to ascertain the reason for the poor performance vis-à-vis the corporate governance mechanism. The dawn of Globalisation is creating ripples in the Indian economy. The researcher is making an attempt to ascertain whether there is any change in the mind set of the business community. The researcher also makes an attempt to trace the step taken by the Government to improve the corporate governance mechanism in India. SEBI is given birth to protect investors. The role played by SEBI vis-à-vis corporate governance is also to be highlighted.

3.2 HISTORY OF INDIAN COMPANIES

Indian corporate root, lies in British soil. The corporate form of organisation is associated with the development of trade and commerce. Indian corporate sector is the gift of British legacy. In Britain around 14th century, a number of large companies were formed in order to take part in international trade. In England, a corporation may be created either by Act of Parliament or by a Royal Charter or by prescription. At common law, the Crown had the prerogative of granting charters of incorporation. In the beginning, companies were formed by obtaining Royal Charter. A few of those chartered companies

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1 Sudip Dutta, Family Business in India, Response Books.
2 Oxford Junior Encyclopaedia.
worth mentioning are the Company of Merchant Adventures, The East India Company and the Hudson’s Bay Company.

The British Empire entered the country only through the corporate form. The East India Company entered India for trading purpose. The company was established by a Royal Charter for that purpose. Indeed, the British monarch granted charter to a number of companies at that time, for trading purposes in different countries. The American colonies were products of two British companies, viz., Virginia Company of London and Virginia Company of Plymouth, both were chartered companies, established in 1606. Similarly, a number of companies from other European countries also entered India for trading around that time.

After the English Revolution of 1688, the King’s authority over the financial and commercial matters of the country began to recede: Companies started to be incorporated by the Act of Parliament. The first company formed by Act of Parliament was the Bank of England in 1694. With the passage of the time, many companies appeared in the scene with a lot of promises and disappeared after collecting money from the innocent investors. Then came the Bubble Act of 1720 to protect the innocent investors, from the companies, which appeared and disappeared as bubbles. However by the Joint Stock Companies Act of 1844, for the first time it was provided that a Company could be incorporated by registration without obtaining a Royal Charter or sanction by a special Act of Parliament. Then the Limited Liability Act was passed in 1855 which was repealed in 1862 under the title of the Companies Act.

The modern company legislation in India followed substantially on the English Company Law. That is why it is usual to call that Indian company acts are the most cherished children of the English brains. Following the Joint Stock

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Companies Act, 1844 in Britain the first pioneering legislation in India in this field was passed under the title of the Registration of Joint-Stock Companies in 1850. The corporate sector witnessed new legislation in the years 1857 and 1860. In 1866, an Act consolidating the earlier legislation was passed. That Act provided inter-alia for incorporation, regulation and winding up of companies and other Associations. Two other major consolidations of the Acts, in the first half of the present century, were passed in 1913 and 1936. Both of them followed their parent legislation in Britain. The present Indian Companies Act of 1956 was enacted, to incorporate our constitutional requirement, in the sixth year of the Republic of India. The Act of 1956 is subsequently amended as and when need arises.\(^5\)

### 3.3 GROWTH OF INDIAN CORPORATE SECTOR

The number of companies in 1956-57, when the Companies Act, 1956 came into being, was merely 29,337 with a paid-up-capital of Rs.1078 crores. As against this, 5,04,884 companies limited by share are registered in the country as on 31\(^{st}\) Dec., 1998. The Table 3.1 given below indicates the state-wise distribution of companies at work as on 31\(^{st}\) December 98. The paid-up capital of these companies is estimated to be around Rs.2,04,000 crores as on 31\(^{st}\) March, 98. About 86% of these are private limited and the remaining 14% are public limited companies. There are 1232 companies belonging to Central Government and State Governments which are called the Government companies. Besides, there are 2,701 companies with liability limited by guarantee and Association not for profit and 422 companies with unlimited liability. These particulars are shown in:

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\(^5\) H.K.Saharay, Principles and Practice of Company Law in India, Nabobharat Publishers, Calcutta.
### Table 3.1
COMPAANIES LIMITED BY SHARES AT WORK AS ON 31st DECEMBER’98 STATEWISE DISTRIBUTION

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>State</th>
<th>Public</th>
<th>Private</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Andhra Pradesh</td>
<td>5,216</td>
<td>24,744</td>
<td>29,960</td>
</tr>
<tr>
<td>2</td>
<td>Assam</td>
<td>544</td>
<td>3,093</td>
<td>3,637</td>
</tr>
<tr>
<td>3</td>
<td>Bihar</td>
<td>1,433</td>
<td>6,554</td>
<td>7,987</td>
</tr>
<tr>
<td>4</td>
<td>Gujarat</td>
<td>5,142</td>
<td>28,552</td>
<td>33,694</td>
</tr>
<tr>
<td>5</td>
<td>Haryana</td>
<td>649</td>
<td>4,480</td>
<td>5,129</td>
</tr>
<tr>
<td>6</td>
<td>Himachal Pradesh</td>
<td>304</td>
<td>1,426</td>
<td>1,730</td>
</tr>
<tr>
<td>7</td>
<td>Jammu &amp; Kashmir</td>
<td>189</td>
<td>1,432</td>
<td>1,621</td>
</tr>
<tr>
<td>8</td>
<td>Karnataka</td>
<td>2,346</td>
<td>19,903</td>
<td>22,249</td>
</tr>
<tr>
<td>9</td>
<td>Kerala</td>
<td>1,320</td>
<td>9,365</td>
<td>10,685</td>
</tr>
<tr>
<td>10</td>
<td>Madhya Pradesh</td>
<td>1,716</td>
<td>10,556</td>
<td>12,272</td>
</tr>
<tr>
<td>11</td>
<td>Maharashtra</td>
<td>11,030</td>
<td>97,080</td>
<td>108,110</td>
</tr>
<tr>
<td>12</td>
<td>Manipur</td>
<td>20</td>
<td>129</td>
<td>149</td>
</tr>
<tr>
<td>13</td>
<td>Meghalaya</td>
<td>42</td>
<td>185</td>
<td>227</td>
</tr>
<tr>
<td>14</td>
<td>Nagaland</td>
<td>12</td>
<td>233</td>
<td>245</td>
</tr>
<tr>
<td>15</td>
<td>Orissa</td>
<td>791</td>
<td>4,297</td>
<td>5,088</td>
</tr>
<tr>
<td>16</td>
<td>Punjab</td>
<td>1,963</td>
<td>10,504</td>
<td>12,467</td>
</tr>
<tr>
<td>17</td>
<td>Rajasthan</td>
<td>1,623</td>
<td>12,464</td>
<td>14,087</td>
</tr>
<tr>
<td>18</td>
<td>Tamil Nadu</td>
<td>7,393</td>
<td>36,552</td>
<td>43,945</td>
</tr>
<tr>
<td>19</td>
<td>Tripura</td>
<td>8</td>
<td>51</td>
<td>59</td>
</tr>
<tr>
<td>20</td>
<td>Uttar Pradesh</td>
<td>4,820</td>
<td>16,793</td>
<td>21,613</td>
</tr>
<tr>
<td>21</td>
<td>West Bengal</td>
<td>10,101</td>
<td>57,989</td>
<td>68,090</td>
</tr>
<tr>
<td>22</td>
<td>A &amp; N Island</td>
<td>1</td>
<td>9</td>
<td>10</td>
</tr>
<tr>
<td>23</td>
<td>Arunachal Pradesh</td>
<td>10</td>
<td>174</td>
<td>184</td>
</tr>
<tr>
<td>24</td>
<td>Chandigarh</td>
<td>1,152</td>
<td>3,908</td>
<td>5,060</td>
</tr>
<tr>
<td>25</td>
<td>D &amp; N Haveli</td>
<td>33</td>
<td>78</td>
<td>111</td>
</tr>
<tr>
<td>26</td>
<td>Delhi</td>
<td>12,101</td>
<td>80,845</td>
<td>92,946</td>
</tr>
<tr>
<td>27</td>
<td>Goa</td>
<td>276</td>
<td>1,965</td>
<td>2,241</td>
</tr>
<tr>
<td>28</td>
<td>Daman &amp; Diu</td>
<td>27</td>
<td>58</td>
<td>85</td>
</tr>
<tr>
<td>29</td>
<td>Lakshadweep</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>30</td>
<td>Mizoram</td>
<td>1</td>
<td>21</td>
<td>22</td>
</tr>
<tr>
<td>31</td>
<td>Pondicherry</td>
<td>215</td>
<td>965</td>
<td>1,180</td>
</tr>
<tr>
<td></td>
<td><strong>TOTAL</strong></td>
<td>70,478</td>
<td>4,34,406</td>
<td>5,04,884</td>
</tr>
</tbody>
</table>

The non-Government private limited companies accounted for 70% of the total companies in 1957. Their number has increased substantially and in 1998 they account for about 86% of the total number of companies. Correspondingly, non-Government public limited companies which accounted for about 30% of the total number of companies in 1957, now account for only 14%. There has been no change in the percentage share of the Government companies which remains at 0.3% both in 1957 and 1997. The non-Government companies (both public and private taken together) had a paid-up-capital which accounted for 93% in total paid up capital of all the companies in 1957 while the Government companies accounted for only 7%. There has been a perceptible change in the percentage share in the paid up capital of the Government and non-Government companies. While the percentage share of the non-Government companies has been reduced to around 57% in 1997 that of the Government companies has increased from a mere 7% in 1957 to about 43% in 1997. Table 3.2 presents the growth of companies during 1956-57 to 1991-92.
Table 3.2
Companies at work 1956-57 to 1991-92
(Capital Rs. in crores)

<table>
<thead>
<tr>
<th>As on 31st March</th>
<th>Government Companies</th>
<th>Non-Government Companies</th>
<th>Total Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>Paid up Capital</td>
<td>No.</td>
</tr>
<tr>
<td>1957</td>
<td>74</td>
<td>72.6</td>
<td>29,283</td>
</tr>
<tr>
<td>1958</td>
<td>91</td>
<td>256.8</td>
<td>28,189</td>
</tr>
<tr>
<td>1959</td>
<td>104</td>
<td>428.9</td>
<td>27,299</td>
</tr>
<tr>
<td>1960</td>
<td>125</td>
<td>477.2</td>
<td>26,772</td>
</tr>
<tr>
<td>1961</td>
<td>142</td>
<td>547.0</td>
<td>26,007</td>
</tr>
<tr>
<td>1962</td>
<td>154</td>
<td>629.7</td>
<td>24,821</td>
</tr>
<tr>
<td>1963</td>
<td>160</td>
<td>786.2</td>
<td>25,462</td>
</tr>
<tr>
<td>1964</td>
<td>176</td>
<td>960.8</td>
<td>25,756</td>
</tr>
<tr>
<td>1965</td>
<td>183</td>
<td>1,114.9</td>
<td>26,038</td>
</tr>
<tr>
<td>1966</td>
<td>240</td>
<td>1,247.7</td>
<td>26,551</td>
</tr>
<tr>
<td>1967</td>
<td>232</td>
<td>1,391.5</td>
<td>26,795</td>
</tr>
<tr>
<td>1968</td>
<td>241</td>
<td>1,559.3</td>
<td>27,103</td>
</tr>
<tr>
<td>1969</td>
<td>259</td>
<td>1,714.9</td>
<td>27,765</td>
</tr>
<tr>
<td>1970</td>
<td>282</td>
<td>1,790.6</td>
<td>28,727</td>
</tr>
<tr>
<td>1971</td>
<td>314</td>
<td>2,064.4</td>
<td>30,008</td>
</tr>
<tr>
<td>1972</td>
<td>352</td>
<td>2,369.1</td>
<td>31,195</td>
</tr>
<tr>
<td>1973</td>
<td>390</td>
<td>2,998.4</td>
<td>33,966</td>
</tr>
<tr>
<td>1974</td>
<td>450</td>
<td>4,643.1</td>
<td>37,035</td>
</tr>
<tr>
<td>1975</td>
<td>573</td>
<td>4,966.0</td>
<td>40,007</td>
</tr>
<tr>
<td>1976</td>
<td>651</td>
<td>6,122.3</td>
<td>42,755</td>
</tr>
<tr>
<td>1977</td>
<td>701</td>
<td>7,174.5</td>
<td>45,165</td>
</tr>
<tr>
<td>1978</td>
<td>745</td>
<td>8,527.6</td>
<td>47,549</td>
</tr>
<tr>
<td>1979</td>
<td>782</td>
<td>8,315.2</td>
<td>50,736</td>
</tr>
<tr>
<td>1980</td>
<td>825</td>
<td>10,070.3</td>
<td>55,668</td>
</tr>
<tr>
<td>1981</td>
<td>851</td>
<td>11,442.6</td>
<td>64,706</td>
</tr>
<tr>
<td>1982</td>
<td>894</td>
<td>13,309.3</td>
<td>74,300</td>
</tr>
<tr>
<td>1983</td>
<td>943</td>
<td>16,734.9</td>
<td>84,869</td>
</tr>
<tr>
<td>1984</td>
<td>973</td>
<td>19,510.6</td>
<td>96,271</td>
</tr>
<tr>
<td>1985</td>
<td>980</td>
<td>22,447.0</td>
<td>108,329</td>
</tr>
<tr>
<td>1986</td>
<td>1,020</td>
<td>27,087.8</td>
<td>123,359</td>
</tr>
<tr>
<td>1987</td>
<td>1,053</td>
<td>32,872.8</td>
<td>136,917</td>
</tr>
<tr>
<td>1988</td>
<td>1,104</td>
<td>37,169.3</td>
<td>157,220</td>
</tr>
<tr>
<td>1989</td>
<td>1,134</td>
<td>42,572.4</td>
<td>179,194</td>
</tr>
<tr>
<td>1990</td>
<td>1,167</td>
<td>54,484.6</td>
<td>203,285</td>
</tr>
<tr>
<td>1991</td>
<td>1,180</td>
<td>57,911.0</td>
<td>249,181</td>
</tr>
</tbody>
</table>

Source: Company News and Notes, Vol.XXX. April, 1993. No. 10
Table 3.3
Non Government Companies Limited by shares registered in Tamilnadu

<table>
<thead>
<tr>
<th>Years</th>
<th>No. of Companies</th>
<th>Authorised Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>Percentage to Total companies registered all over India</td>
</tr>
<tr>
<td>1990-91</td>
<td>2,024</td>
<td>9.1</td>
</tr>
<tr>
<td>1991-92</td>
<td>2,374</td>
<td>9.1</td>
</tr>
<tr>
<td>1992-93</td>
<td>2,782</td>
<td>9.5</td>
</tr>
<tr>
<td>1993-94</td>
<td>3,084</td>
<td>10.2</td>
</tr>
<tr>
<td>1994-95</td>
<td>4,547</td>
<td>9.49</td>
</tr>
</tbody>
</table>

Source: Company News & Notes

Though the growth of companies in the post-independent era is brisk, the pace picked up and increased at a tremendous period after the initiation of LPG programmes. The Indian corporate sector witnessed a phenomenal growth during the nineties. The change can be attributed the reforms initiated by the government from June, 1991 onwards. Though the corporate sector gathered momentum from the eighties, the velocity picked up from the year 1991. The securities market as well as the statistics of new company registration clearly portrays the situation.

“The 1990s was the decade of reforms of the Indian economy. It was the period of transformation of the Indian securities market; it was the age of the emergence of the securities market from the backwaters into the mainstream of the Indian financial system. The process of expansion of the securities of market had actually begun in the 1980’s and its role in the economy had been growing since then; but it was during the 1990s that the process really accelerated, spurred by economic reforms. Several key quantitative and qualitative features marked the transformation of the securities market. One quantitative factor which highlights the growth of the securities market is the number of issues and
the amount of share capital raised. Nearly 6700 public and rights issues raised over Rs.1,291 billion on the stock exchanges between 1991-92 and 1998-99, which is six times the amount of Rs.195 billion mobilised similarly during the ten year period 1980-81 to 1989-90".

Table 3.4 shows the amount of capital raised through public and rights issue in India during the period 1991-92 to 1999-2000. This period is the golden period for the Indian corporate sector, as very huge amount is mobilised from the public.

Table 3.4

Capital Raised through Public and Rights Issues

<table>
<thead>
<tr>
<th>Year</th>
<th>Public</th>
<th></th>
<th>Rights</th>
<th></th>
<th>Total</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Amount</td>
<td>Number</td>
<td>Amount</td>
<td>Number</td>
<td>Amount</td>
</tr>
<tr>
<td>1991-92</td>
<td>206</td>
<td>23.58</td>
<td>257</td>
<td>38.57</td>
<td>463</td>
<td>62.15</td>
</tr>
<tr>
<td>1992-93</td>
<td>546</td>
<td>488</td>
<td>488</td>
<td>108.95</td>
<td>1034</td>
<td>184.55</td>
</tr>
<tr>
<td>1993-94</td>
<td>773</td>
<td>370</td>
<td>370</td>
<td>89.23</td>
<td>1143</td>
<td>242.90</td>
</tr>
<tr>
<td>1994-95</td>
<td>1342</td>
<td>350</td>
<td>350</td>
<td>65.88</td>
<td>192</td>
<td>276.32</td>
</tr>
<tr>
<td>1995-96</td>
<td>1426</td>
<td>299</td>
<td>299</td>
<td>65.64</td>
<td>1725</td>
<td>208.03</td>
</tr>
<tr>
<td>1996-97</td>
<td>71</td>
<td>131</td>
<td>131</td>
<td>27.19</td>
<td>882</td>
<td>142.76</td>
</tr>
<tr>
<td>1997-98</td>
<td>62</td>
<td>49</td>
<td>49</td>
<td>17.08</td>
<td>75</td>
<td>45.70</td>
</tr>
<tr>
<td>1999-99</td>
<td>32</td>
<td>26</td>
<td>26</td>
<td>5.67</td>
<td>58</td>
<td>55.86</td>
</tr>
<tr>
<td>1999-00</td>
<td>55</td>
<td>27</td>
<td>27</td>
<td>15.56</td>
<td>82</td>
<td>72.89</td>
</tr>
<tr>
<td>Total</td>
<td>5,193</td>
<td>857.39</td>
<td>1,997</td>
<td>433.77</td>
<td>6,691</td>
<td>1,291.16</td>
</tr>
</tbody>
</table>

Source: The Developments in the Indian Securities Market in the Decade of the 1990s, Survey of Indian Investors, SEBI, Mumbai.

The private corporate sector has been the vanguard of the economy for about a century. It has grown faster than the rest of the economy and forms the majority of India's industry in terms of numbers, investments, profits and most of the quantifiable measures. However, the contribution of the private (corporate) sector in the nation building has received less importance. Even the

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academicians have not discussed in detail in various forums about the contribution of the corporate sector. The private sector has not received so much attention as compared to the public sector. The private sector has rarely taken pride of its place in the literature on Indian industry and its achievements were barely mentioned in the planned economy regime that dominated Indian industrial growth between 1947 and 1991. Since independence, the academicians and the press have been averse towards the achievements of private sector. Within the private sector family businesses dominate Indian private industry, both in number and in performance. About seventy five percent of the largest companies are family businesses. There is some variation in the number of family firms in the biggest companies. The Business India Super 100 puts the number of family businesses in the top 100 companies by sales at around 75 per cent. The Business Today 500, which includes some public sector companies, shows a lower number of family businesses The 1990 Economic Times list of 200 companies according to capital employed has 36 multinational and professional firms. Family firms are 99.9 per cent of all Indian companies.\(^7\)

In 1947, the Indian family business sector was smaller. Of the 127 largest companies in India, 58 were under foreign or British management at the time of Independence. The role of multinational companies in India has also decreased since Independence. However, with the launch of Liberalisation, Privatisation and Globalisation (LPG) programme, the multinational companies have started changing their pace. Family-owned companies had a huge 67.95% of market capitalisation in 1992 which has now shrunk to 55.71%. At the same time, the share of the transnationals has gone up from 22.38% to 33.69%.\(^8\)

\(^7\) Sudipt Dutta, Family Business in India, Response Books, A division of Sage Publications, New Delhi

3.4 CORPORATE GOVERNANCE IN INDIA

The Indian companies are governed by the Companies Act, 1956. It is the largest statute of our country with 658 main sections, supplemented by a number of sub-sections and sub-clauses, XV schedules complemented with a good number of periodic circulars, rules, notifications and guidelines. According to the Companies Act, 1956 a company may be either a private limited or public limited company. Only a public limited company can get its shares listed in a stock exchange. To list the shares of a company in a stock exchange, the company concerned has to approach the desired concerned stock exchanges where it wants to get it’s shares listed. Securities Exchange Board of India (SEBI) is the capital market regulator. With reference to a listed company, the company has to get the clearance also from the SEBI before going for a public issue.

3.4.1 Corporate Governance Mechanism

The company being an artificial person cannot act without the help of a human agency. Therefore, a mechanism is required for the conduct of the business. The mechanism has been provided by the Companies Act, 1956. The Companies Act, the constitution of the corporate citizens, empowers the shareholders the supreme authority to run the company. They transact the businesses through the general body meeting. They delegate the managerial powers to a committee known as Board of Directors. The Board of Directors is constituted by the shareholders. The shareholders will elect the directors in the annual general meeting who are the members of the board. The powers of the board can be exercised only collectively and not individually. Section 291 empowers the board to manage the affairs of the company.

Formerly, four types of professional management were recognised, namely, managing director, managing agent, secretaries and treasurers and
But with effect from April 3, 1970, management by managing agents and secretaries and treasurers has been banned. Now the choice is only between a managing director and manager. A company can have only one of them.

A managing director as defined in the Act means "a director who is entrusted with substantial powers of management which would not otherwise be exercisable by him. The term includes a director occupying the position of a managing director, by whatever name called". The "substantial powers of management" may be conferred upon him by virtue of an agreement with the company, or of a resolution of the company or its board, or by virtue of its Memorandum or Articles.

In English law, a managing director can be appointed only if there is a power to that effect in the company’s Articles. The "substantial powers of management" which are conferred upon a managing director may be revoked or reduced or otherwise altered by the board itself. Under the present set-up the CEO formulates objectives and policies and takes important managerial decisions after a thorough consideration of the problems and circumstances of the company.

One other agency in the governance mechanism is auditor. Since the management is separated from the owners, there arises a need to keep a watch on the management, with whom the funds are entrusted. To vouchsafe the funds position and its deployment an external agency is appointed, who is termed as auditor. The auditors certify the genuineness of the accounts prepared and

12 Ibid.
presented to them by the Board of Directors. Auditors are appointed by the shareholders in the annual general meeting. Shareholders also fix the remuneration. In turn, auditors report to the shareholders in the annual general meeting, about the accounts. The act provides complete independence to the auditors, which is essential for the efficient discharge of the duties of the auditors. If the annual general meeting fails to appoint an auditor, the Government will appoint the auditor for that company and remuneration is also fixed by them.

The Indian companies adopt the following features vis-à-vis corporate governance:

(i) Shareholders’ Approach in the constitution of the Board
(ii) Unitary Board
(iii) Hybrid of insider and oversight board

3.4.1.1 Shareholders’ Approach

The Indian company law is the brain child of English legal luminaries. Hence, we toe the line of British people in the constitution of the Board of Directors. Under the Indian Companies Act, 1956 shareholders are the supreme authority in the constitution of the board. India adopts the shareholders’ approach in the governance of the company. The shareholders are the owners of the company. They are the competent persons to constitute the Board of Directors, unlike the German model, where the board members are elected both by the shareholders as well as the employees. The directors are elected by an ordinary resolution, a simple majority, in the annual general meeting. Therefore, a group which enjoys 51 per cent and above of voting rights can monopolise the entire directorship with their representatives. Thus the board represents only 51 per cent of shareholders and the remaining 49 percent of the shareholders are left out. They are not given any representation in the board.
The legislature, therefore, while enacting the Companies Act, 1956, wisely thought of the interests of minority shareholders. The principle of proportional representation was thought of as early as 1936 in India. The Joint Committee that is revising the Companies Act, 1956 in India recommended for a provision on the line of proportional representation. At that time, it was styled as revolutionary. However, the proposal was rejected as it was against the fundamental concept of joint stock company where every shareholder, whether the minority or not, had to take the risk of having the acquiesce with the wishes of the majority.

Keeping in view of the needs of economy, alternative methods of election of directors were considered while framing the Companies Act, 1956. It was argued that if cumulative method of voting or any other method of proportional method was adopted, it might result in the Board of Directors becoming a contending field for warring factions and this in turn might render the smooth working of the business of the company virtually impossible. However, the Indian Legislature deviated from the common British practice of electing directors by a simple majority and accordingly enacted section 265. Now the minorities have an opportunity of placing their representatives on the Board of Directors, which they would never have had under a system of straight voting. Section 265 is a new section which did not have any parallel either in the Act of 1913 or any of the contemporary English Act, including the English Companies Act, 1948.
Section 265 of the Companies Act, says that “Notwithstanding anything contained in this Act, the Articles of a company may provide for the appointment of not less than two-thirds of the total number of the directors of a public company or of a private company which is a subsidiary of a public company, according to the principle of proportional representation, whether by the single transferable vote or by a system of cumulative voting or otherwise, the appointments being made once in every three years and interim casual vacancies being filled in accordance with the provisions, mutatis mutandis of section 262”

Keeping in view of the society’s welfare, the choice is left to the shareholders either to have straight voting or proportional representation. According to Section 265 of the Companies Act, 1956, if the Articles of Association provide, two-thirds of the total number of directors of a public limited company may be appointed by the principle of proportional representation. Therefore, it is not mandatory for all the companies to adopt the principle of proportional representation. The result of this condition, viz., the permission of the Articles of Association is farcical situation. The proclamation that the Government is providing the minorities a chance to get an accommodation in the berth of the board amounts to a paradise existing in paper only. Such minority board representation will never arise in reality. To have that clause in the Articles of Association, either the promoter would have included such clause at the time of incorporation, which a promoter normally would not do. In the case of an existing company, where the Article does not provide for such proportional representation, it requires an alteration of Articles of Association. This requires a special resolution besides other formalities. The minority shareholders who are not able to mobilise even a simple majority for electing the director of their choice, could not mobilise a three-fourth majority

for passing a special resolution to alter the Articles of Association. Since the principle of proportional representation is subject to the approval by the Articles of Association, virtually no company can have the proportional voting right for the election of directors. The present researcher while conducting the survey comes to know that no company offers this facility in their Article. However, it seems that the subsequent Government is serious in this proposal. An attempt is made to set right this anomaly.

The ineffectiveness of section 265 led to the amendment to section 252 in the Companies (Second Amendment Bill) 1999. The amendment, indeed interesting, stipulates that a company having a paid-up capital of more than Rs. 5 crores and 1,000 or more small shareholders (those with shares of nominal value of Rs.20,000 or less) should have at least one director elected by such small shareholders in the prescribed manner. This will presumably be prescribed later. This is an indirect method of proportionate representation, where the ineffectiveness of section 265 sought to be rectified by the law makers.

It is interesting to note that about fifty per cent of the states in the U.S., are adopting cumulative voting for the election of directors. It is mandatory and not optional. However, in the remaining states it is optional. The system of cumulative voting has been adopted in the countries like Ghana and Ontario. The practice of Japan is yet different. It is halfway between compulsory and optional. The shareholders can ask for cumulative voting provided the Articles permit it. In this way it is optional. Again the system permits the cumulative voting provided the shareholders who claim the principle of cumulative voting

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hold at least twenty five percent of the voting rights.\textsuperscript{24} Though the principle was advocated in U.S.A., and South Africa, the principle was not accommodated in the Companies Act of the respective nations.

If the Articles of Association permit proportional representation in a company, then the election of the entire Board should be conducted once in three years. Retirement by rotation does not apply. However, interim vacancies can be filled up in accordance with the provisions, \textit{mutatis mutandis}, of section 262. One another implication of the operation of section 265 is that section 264 is not applicable, i.e., a company cannot remove a director in the course of the three year term by a resolution.

The company law is framed with a number of checks and balances. The conflict between the minority and majority is an area which requires delicate balance. The minority is bound to accept the decisions of the majority. The will of the majority should prevail over the minority. Both in England and in India, the majority enjoys a supreme position. The members of the company have to submit to the will of the majority as laid down in the famous case Foss Vs. Harbottle.\textsuperscript{25}

Having granted the supremacy for the majority, the Companies Act, 1956 places a check on the supremacy of the majority also. When oppression or mismanagement of a company aggrieves the members, the Act grants them remedy by way of two alternatives courses, even though they are not majority. They may invoke either the powers of the court or the powers of the Company Law Board for prevention of oppression and mismanagement of the company. The Company Law Board has been empowered by section 408 to direct the company to amend its Articles in the manner provided in section 265 and make


fresh appointments of Directors in pursuance of the Articles so amended. Thus, the minority can check the excesses even if the majority commits it.

The reason for not adopting the stakeholders approach in the governance of the company can be traced to the historical factor. As a British colony, the earlier companies Acts were legislated on the models of English Company Law. Though it is not compulsory to copy the English Law such after the Independence, other factors also favoured the continuation of the British model. The crux of the stakeholders’ model is labour representation in the decision making body. The corpus of Indian labour laws is strong enough to protect the interest of workers in the organised sector. Employees as well as trade unions are well aware of their legal rights. In contrast, there are very little in terms of corporate law and practices that protect the rights of creditors and shareholders. Hence the Companies Act, 1956 having given sufficient protection to the creditors, have also empowered the shareholders to govern the company.

3.4.1.2 Unitary Board

The model granted by the Companies Act, 1956 with reference to the structure of the board is Unitary Board Model, compared to the Two-tier model followed in many of the European countries. In Germany, the management is bifurcated in to two-tier, the first tier being the supervisory board comprising the representative of shareholders and employees and the management board which is constituted by the supervisory board. In India, the role played by the management board is played by the managing director or manager.
3.4.1.3 Hybrid of Insider and Oversight Board

The Companies Act, 1956 is silent whether the board should be an insider board or oversight board. It does not prohibit a director to be a full time employee of the company as under German model: Again, there is no compulsion that a director should be a full time executive of the company, as in the case of Japanese companies. It permits a contingency approach. Depending upon the need and the necessity, the directors can be either a full time official of the company or he can act only as a director, be an outside director. The term
Executive Director and Non-executive Director is not found in the Companies Act. The act defines a Whole-time director, whose role and duties are similar to an Executive Director. Therefore, regarding the question of Insider Board or Oversight Board, Indian board lies in between the insider board and oversight board. It is a hybrid version of Inside Board and Oversight Board. A director can serve the board only or being the director of a company, he can also work in the company in some capacity. Unlike the German model, the members are not prevented in occupying the position both in the board as well as in the day-to-day administrative organ. The Indian model is similar to U.S.A. and U.K. where pure insider board or oversight board is not a mandatory condition. Figure 1 depicts the corporate governance structure of Indian companies.

3.4.2 Critical review of Corporate Governance in India

According to law, shareholders appear to possess effective powers for the control of the company’s affairs. These powers include the right to elect directors, the right to appoint auditors who must report to them on the annual accounts of the company, the right to convene meetings and to decide the matters which are reserved for disposal by shareholders by special or ordinary resolution. The meetings are supposed to be conducted properly and matters are decided by voting after shareholders have been given proper opportunity to speak. Thus, in theory, company management gives the impression of a perfect democracy in which the general mass of shareholders wield the supreme authority in all matters concerning the management of the company.

However, in practice, the management of companies exhibits some marked features of oligarchy. In actual practice, management is the exclusive monopoly of a few business leaders. These persons constitute an ‘inner ring’ or a well-organised corporate group which is in a position to manipulate the working of the company to its own advantage without showing much regard for
the shareholders’ interests. The shareholders’ control over directors is purely illusory.

Moreover, it appears that the initiative in the management of companies has passed into the hands of the Board of Directors. However, in reality the managing director will be practically running the show. In the case of first generation entrepreneurs the managing director will be the de facto power centre. Neither the board nor the shareholders have any influence of significance. The board is constituted as per the wishes of the managing director and not the shareholders. The board colleagues are hand picked by the managing director. The Board of Directors is usually packed with people who are puppets in the hands of a family controlling an industrial house.

This had led Peter Drucker to remark, “In reality, the Board as conceived by the law-makers is at best a tired fiction. It is perhaps not too much to say that it has become a shadow king.” As it is, it has to be taken to mean that the Board has no important function to perform. As it is, the ultimate responsibility under the present set-up of company management rests with the Board of Directors. It has, therefore, to perform the important function of approving the company’s object policies of looking critically at the profit planning of company of acting as the Supreme Court in regard to organisational problems and of keeping its hand on the pulse of the company. To quote Drucker again, “It is an organ of review of appraisal. Only in crisis it becomes an organ of action.”

The chief executives, being whole-time officers of the company, can naturally devote greater time and attention to the matters connected with the management of a company. Moreover, their continuous and close contact with the operations of the company places them in a far more advantageous position in respect of management of company’s affairs than the Board which meets only occasionally. As Newman puts it, “It is the full-time executive who must carry
the responsibility for the basic exploration and analysis of present and future problems.”

The top executive performs a good deal of homework for the benefit of the Board of Directors. It is, indeed, encouraging particularly in view of the increasing complexity of company operations and the other preoccupations of company directors. As a result, in a number of companies the board became a mere rubber stamp.

Bureaucrats may not be able to take a detached and objective view of company operation because they are too much involved in the day-to-day administration. This bias will affect the quality of the decisions. Even more serious is the problem of the Boards of Directors not acting as free agents in the discharge of their duties. Prior to the abolition of the managing agency system, the managing agents controlled the Boards of Directors of companies and used them as mere tools. Even after the abolition of managing agency system, there is a danger of their being pressurised by corporate groups and big industrial houses.

The following paragraphs present the considered opinion of luminaries in the public life about the state of Corporate Governance in India:

“The record of corporate governance in India is very poor – stories of accounting jugglaries, siphoning of funds, investing and selling off associate companies and subsidiaries, benefits to promoters at the cost of other shareholders etc., are not uncommon. Culprits are not necessarily ‘over-the-night operators’, names of blue chip companies often appear in these stories. In India companies were managed on the basis of family ties and managers could get away with poor corporate governance due to laxity of shareholders”. The following paragraph exhibits instances of how the corporate affairs had been

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conducted and the opinions of press, experts and public opinions are presented which helps in rating of Indian companies vis-à-vis corporate governance.

Corporate governance is the latest buzzword in business. For the first time in India’s corporate history, so many luminaries from one of the most respected corporate houses were thrown into jail. The murky affairs in that company ripped open the mask of professionalism to reveal an organisation, caught in a vortex of vaulting ambition naked greed and glaring-incompetence. The shameful share-switching episode shows an utter disregard for the law and callous attitude towards shareholders. As many skeletons fell out of corporate cupboards, corporate governance received greater focussed attention. Cadbury hitherto known mainly to kids as chocolates became a management jargon overnight, with the publication of the report of the committee under the chairmanship of Sir Adrian Cadbury, from the famous chocolate making family, on better corporate governance.  

Typically, an Indian company, whether large or small, has a ‘controlling interest’, which is usually the promoting – shareholder group. This group almost completely dominates board appointments and provides top executive management. In other words, it controls both the governing organ and the executive management of the company directly. This system functions reasonably well only when a controlling group is competent, well-intentioned and not too self-seeking. However, controlling groups are often neither competent nor honest, and this is a cause for public concern.

Many promoters ran the companies under their control in the capacity of the board members like their personal fiefdoms. Many did not have managerial capacity and the units turned sick. Profit for self and family was the principal

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motive. Wealth was measured in terms of the amount siphoned out of the company. The directors, who were managing other peoples’ money, as Adam Smith warned, could never be expected to be as vigilant as the earlier partners looking after their own. The promoter was largely not accountable to anyone except himself.

There is something horribly wrong about almost every aspect of the way an average Indian public company is run. The promoters tend to control companies through relatively small stakes, and yet manage to boss over them as if they were personal fiefdoms. The institutional investors refuse to flex their voting muscle, and when they do so it is inevitably on the directions of the government. The ordinary shareholders are ignorant of their rights, and perhaps the only time they raise their choices at company meetings is to ask for higher dividends or more sandwiches. To put it mildly, corporate governance in India is in a holy mess.29

Ninety five per cent or more of Indian companies unfortunately are run like partnership where the shareholder is a legal nuisance to be put up with and not a real owner of the enterprise. Promoters of Indian public companies are very clear in one thing, that the company belongs to them forever and ownership of shareholders is only a judicial fiction. No Indian promoter ever, even, dreams that he is only managing the company on behalf of shareholders and that he can be voted out by them. These promoters go to the public only to collect a zero interest debt called share capital and ownership of the company is not offered to the public. “There was never any confusion in my mind. My son Shrivardhan will inherit my empire,” Mr Goenka told the Economic times. “It’s there in my mind. I plan to hand over the charge of the companies to Shrivardhan once he completes his two-year post-graduate course of MBA,” Mr

Goenka, the Chairman of The Herdillia group, Duncan Goenka group of companies, pointed out.\textsuperscript{30}

Can the future of large enterprises be based on the hereditary principle? Should there not be minimum qualification of experience, education and training before large companies of mindboggling market capitalisation are entrusted to sons and daughters just because they are sons and daughters of promoters?\textsuperscript{31}

“Over time, some family managers indulged in unethical practices, not so much with a view to build local enterprise but for personal greed... With a view to enlarge business empire under their control, many promoters have used profits of flagship companies for promotion of unrelated business. Some of them have structured ownership through a web of companies with the primary purpose of retaining control and at times getting more than their due share of profits”.\textsuperscript{32}

If companies cannot or do not want to improve shareholder value, individual investors are usually helpless. What can you do if you are a shareholder of Escorts, for instance, whose owners pay themselves crores of rupees as salaries but are unable to create value for you. Can you get the company to perform? The owners of Escorts pay themselves crores of rupees as salaries, but the shareholders’ value is languishing.\textsuperscript{33}

“Corporate governance in India has been driven by suspicion about motivation and behaviour of private enterprises, especially large multi-national business houses”.\textsuperscript{34} The following is a typical example of how intelligent people collect money from the public utilising the law of land. It reflects the mind set of a typical Indian promoter. “In just seven years, the 37-year-old, Vijay Kumar Sharma, the Chairman of JVG Group, has risen from being a

\textsuperscript{30} The Economics Time, 17\textsuperscript{th} October 2000.
\textsuperscript{32} N.J.Jhaveri, “Corporate Governance: Why and How”, Chartered Secretary, May 1997, New Delhi.
\textsuperscript{33} The Economics Times, 6\textsuperscript{th} September 2000.
small-time contractor with Swadeshi polytex, earning less than Rs2,500 a month to running a group which on paper has an annual turnover of Rs1,000 crore. He lives in a lavish farmhouse in Delhi and drives around the capital in a range of cars including a BMW, a Mercedes and a Pajero. For some time he even had a helicopter on lease, which he employed to fly to small towns in north India, which form the largest base of his deposit holders. Though two JVG Department stores and JVG Finance did raise nearly Rs.50 crore through public issue in the last two years, the fixed deposits, according to some estimates, accounted for well over Rs1,000 crore. Sharma himself claims the figure is around Rs500 crore. It is based on this money and a host of public issues that he sought to become, in his own worlds, "India’s biggest industrialist with a turnover of over Rs12,000 crore by AD 2000". The company had a turn over of Rs920 crore, with a deposit amount collected from the investors exceeding Rs.1,000 crores. When the deposit holders are demanding the money. Sharma is trying to wash his hands off thousand of small deposits, claiming that the receipts produced by the deposit holders are all fake".  

The law of the land permits such bounty and plunder. This is one type of promoter in Indian corporate sector, who is not at all bothered about ethics and morality.

The architect of CRB scam, Dr Chain Roop Bhansali, resident of Mumbai’s Azad Maidan police lock-up, has proved beyond doubt that it is very easy to be reckless with other people’s money. The ingredients of his success consisted of fine looking prospectuses, slick brochures, few legal loopholes, lax accounting, inadequate supervision, friends in the right places and, of course, a slew of over greedy investors.

The mental make up of Indian business community led the Editor of a leading daily "The Economic times" to make the following comments:

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35 Corporate reports, Business India, November 17th, 1997.
“Hopes of corporate governance?

In scam-ridden India, investors’ confidence has taken a severe beating, making corporate governance a key issue. However, nothing much will happen unless company directors themselves realise the importance of governance.”

“A highly respected multinational corporation situated in Eastern India has allegedly fixed its books to show high exports, high profits, etc. But of course this is on subsidy. As many as 2,500 of 3,900 companies that got listed between 1991 and 1996 have completely disappeared. It is almost impossible to discover what happened to these corporations as there are no annual reports or any other form of published information about them.”

“The LM Thapar flagship, Ballarpur Industries Ltd (BILT) is being trifurcated into three entities BILT Paper goes to Vikram Thapar, BILT Chemicals will go to Gautam Thapar. The Thapar controlled management also proposes to divest Rs.200 crores worth of non-strategic assets and real estates.” This is a routine exercise which had been carried out in earlier years.

Restructuring is nothing new at BILT. This effort has been going for the last four years with little to show for results. A few months back, BILT had announced a ridiculous cost cutting effort comprising, among other things, of a slash on perks paid to the top management such as free lunches and refreshments. BILT had claimed that they would be reducing the layers of managements, retrench excess manpower and relocate officials. This latest salvo, is nothing but an effort to hoodwink the masses and financial institutions in to sinking another Rs.100 crores into the misadventures of the Thapars.

The response of a citizen to the proposal of the award for the best record of Corporate Governance is given in the following paragraph. “As well known, some thing is very rotten in the corporate world of our country, barring a

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few shining examples of good governance. Hence the plan of the government is more than welcome. It is also a good gesture that the company with the best record of corporate governance will be given an award.\(^{38}\)

It is well known that most managements are not fair to the common investor and are oblivious to creating shareholder-value. Most promoters initially purchased shares of the company at par and after a few months issued shares to the public at exorbitant prices. This practice has been prevailing around 1994-95.\(^{39}\)

The management not only ignores the shareholders’ interest, but also fails to pay the due amount to the Government, by way of taxes. “Number out of 1538 profit-making companies which did not provide for any corporate tax in 1996-97, in spite of MAT, 343”.\(^{40}\)

“From the moment of its birth, Scindia Steamship faced the hostility of the world’s biggest shipping line, the British India Steamship Corporation, and its doughty chairman, Lord Inchcape, who used every trick in the trade to destroy the company, but failed. From a single-liner outfit in 1919, Scindia Steamship became India’s flagship carrier by 1947, and was one of India’s Top twenty companies well into the 1960s. Until its gerontocratic management achieved what Lord Inchcape never could even with the patronage of British Government: Scindia Steamship has, virtually, sunk without a trace today. What the hostile British competitor wanted to do, which cannot be accomplished during the British regime, had been easily achieved by an Indian business family in the post-independent period”.\(^{41}\)

“Ever since Independence, India’s business class has indulged in furious asset-building, creating mega-empires in the process. A few have survived the

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\(^{40}\) Business India Index, Business India, August 25 - September 1997.

decades, but many have crumbled into the rust of their machinery. An inability to withstand the zephyrs of change, out-dated technology, outright mismanagement, over-stretched resources, poor labour management the reasons for failure are myriad.\(^{42}\)

None of the stakeholders – the boards, the stock market, the bankers, the financial institutions, and the trade unions – has a major monitoring role over the propriety of actions of top management in the corporate sector. Even the government, which has to enforce the laws, has not been in the forefront in exposing the improprieties. Most corporations, both in the public and private sectors, have become a means for the other ends of the promoters. They are not seen as legal entities in their own right and in perpetuity. Conflicts of interest are tolerated with impunity.\(^{43}\)

Corporate governance in India has been driven by suspicion about the motivations and behaviour of private enterprise, especially large multinational businesses. The government has controlled the working of private enterprises through various laws relating to foreign exchange, licensing for capacity creation and expansion, location, control on capital issues, and on credit. Private enterprise was sought to be contained in various ways.\(^{44}\)

Had the Indian business community had little realisation about the principles of Corporate Governance, definitely the to-day's business scenario would have been totally different. The Indian business community was least bothered about the Corporate Governance. The promoters never thought that the business belongs to the shareholders and the former was running the show on behalf of the shareholders. Since the promoters failed to realise this phenomenon, many prosperous companies which were market leaders in one

\(^{42}\) Ibid.
\(^{44}\) Ibid.
product or other, some names which are yesteryears' heroes, are included in the list of obituary. The aggrieved parties are not only outside shareholders but also the same promoter. They are digging their own graves. However in India, as our yesteryears political leaders were suffering from xenophobia, the home trade was fully protected. The entry of foreign companies were more or less banned. If at all they entered, they did subject to a lot of restrictions. As a result, the profile of Indian businesses altogether changed, if we compare the profile at the time of Independence. In 1947, the Indian family business sector was smaller. Of the 127 largest companies in India 58, were under the British management at the time of Independence. The role of multinational companies in India has decreased since then.\textsuperscript{45}

Amazingly, as the Business Today listing of the top fifty business families in 1997 shows, that as many as five groups, apart from the Tatas and the Birlas have managed to stay at the top for the last 50 years: the Lalbhais, the Mafatlals, the Shrirams, the Wadias, and the Walchands. However, at the beginning of the new millenium, the list is still trimmed to either five or four. Hirachand Walchand family was entirely dropped out from the list because of the family feud and other reasons. Why there so many drop outs? Many families vanished into thin air.\textsuperscript{46} The above paragraphs portray the state of corporate governance in India.

There is something horribly wrong about almost every aspect of the way an average Indian public company is run. The promoters tend to control companies through relatively small stakes, and yet manage to boss over them as if they were personal fiefdoms. The institutional investors refuse to flex their voting muscle, and when they do so it is inevitably on the directions of the government. The ordinary shareholders are ignorant of their rights, and perhaps the only time they raise their voices at company meetings is to ask for higher

\textsuperscript{45} Sudip Dutta, Family Business in India, Response Books, A division of Saga Publications, New Delhi.
\textsuperscript{46} Business Today, August 22-September 6, 1997.
dividends or more sandwiches. Although promoters and managers may have adhered to the letter of law, the spirit of the law has been frequently and flagrantly violated in an abysmally poor record of corporate governance. The profile of Indian business will reveal some clue about the state of corporate governance in India. The following paragraphs will throw light on the profile of Indian business in general.

3.5 PROFILE OF INDIAN BUSINESS

The Indian business is more dominated by family business. Growth and prosperity of a nation is to a large extent measured by its industrial development. Statistics from around the world indicate that family run businesses have played a major role in this process and have accounted for a large segment of the industrial sector. The United States’ GDP was over $6.8 trillion in 1995 and the portion of the economy traditionally attributable to family firms is 60% to 75% Thus, the contribution of the family run businesses to the GDP in the United States worked out to approximately $4.1 to $5.1 trillion per year. This represents more than $50,000 per household. Research indicates that “Families and other households are in effect small factories that even in the most advanced nations produce many valuable services and goods. The value of these exceeded 20% of GNP and 40% of world output (Becker1995). Thus there is very little doubt that family-run businesses have assumed lot of importance in each and every area.” India is not an exception to the above phenomenon.

In India, family businesses account for about 70% of the total sales and net profits of the biggest 250 private sector companies. In the earlier days, promoters formed a company, financed the project and also managed the company. It was more a family affair. There is no gainsaying the fact that promoters in India have considerably contributed to the industrial development

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of the country. Over the years, their involvement was becoming less and less, they did not own the company and they had minimal stakes only, with their projects financed by term loans from financial institutions and through public issue of shares and debentures.

A survey in 1996 indicated that, of the top 500 companies, only 140 companies had 50% or more holdings by the promoters. In the remaining 360 companies, many promoters ran them like personal fiefdoms. Many did not have managerial capacity and the units turned sick. Profit for self and family was the principal motive. Wealth was measured in terms of the amount siphoned out of the company. The directors, who were managing other peoples' money, as Adam Smith warned, could never be expected to be as vigilant as in the earlier days, where partners were looking after their own. The promoter was largely not accountable to anyone except himself. Mr. R.K. Talwar, the noted banker, said in 1983: “The board is generally sought to be controlled by a single individual or a small group of individuals within the board or sometimes even outside, as a kind of extra-constitutional authority. The individual or group may be averse to expression of views not exactly in tune with his or its own”. Many of these firms are still run on questionable lines. Very recently, the CLB appointed director of a well known company said about the functioning of the board. “The whole time directors may be taking orders directly from the Chairman. Many of the things may not be illegal but they are highly questionable. It was a one man show by the non-executive chairman who also holds the controlling interest. The whole time directors seem to be terribly afraid of the chairman. The company needs a board which can be independent of the promoters’ control as this is essential for restoring the company’s credibility and for preventing irregularities for taking place.”

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48 Ibid.
49 P.S. Hariharan, “Corporate Governance And Board of Directors”, Souvenir released at Silver Jubilee National Convention and Third International Conference, Institute of Company Secretaries of India, New Delhi
Big families have shaped up the big industries, an indisputable fact. In vehicles, for example, the Tatas make lorries, the Birlas make Ambassador cars, the Bajaj family makes two wheelers and the Mahindras make jeeps. Until recently, they faced little competition. They diversified into any business where they could get to operate. In the post-independence and the pre-liberalisation era, the Indian family run businesses have grown on state directed investment and a domestic market that was closed to foreigners. With the changes that are taking place in the country, family businesses are strategising for growth. Outsourcing, acquisitions and mergers are emerging as the major strategies for survival. However, most family business are characterised by the problems of death, taxes, family feuds and succession squabbles. Walchand Hirachand founded business changed hands from the scions of the founder family members due to the above reasons. Business families are not only splitting; they are fast losing value. Family owned companies had a huge 67.95% of market capitalisation in 1992 which has now shrunk to 55.71%. At the same time the share of the transnational has gone up from 22.38% to 33.69%.

Borrowing from public sector institutions was easy and company law made it easy to control subsidiaries through very small shareholdings. The Tata Empire embraces some 80 and odd companies making everything from Tea to watches in which the parent company’s average stake is rarely above 15%, in the pre-LPG period. The fear of take-over compelled many companies to increase their stake. Further, the abolition of Controller of Capital Issues Act and a free pricing regime motivated many business houses to increase their stake at an issue price which is a throw away price compared to the prevailing market price. Here again the business houses have not bothered about the loss of value to the existing shareholders, though the remaining lot constitutes a majority. With

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profits harder to make and a relatively small equity in a company, many family firms are being forced to weed their portfolios, retiring from investments they rushed into during easier times. The Mahindras family has already withdrawn from oil drilling and instrumentation to concentrate on cars. The Thapars are trying to focus on Ballarpur industries on its core activities of paper and chemicals. Many of these enterprises have the fear of being taken over by some other organisations. Tatas have sold their stake in TOMCO, ACC and a host of other companies in order to have core competency. Younger members of the leading business families in India, specially those who have been trained in western schools, seem much more at home with novel ideas such as focusing on core competencies. It is the beginning of the dawn of the realisation of the shareholders' value, in the minds of the promoters.

3.6 REASONS FOR THE POOR GOVERNANCE PRACTICES

The ills of the present day corporate governance can be attributed to the following factors:

3.6.1 Managing Agency System

Managing agency is a peculiar institution created by English business houses in India during the British rule in order to control and manage a number of industrial organisation. The Companies Act, 1913 gave statutory recognition to this institution as a reward for service it rendered to the development of industry and commerce in India. Subsequently, the managing agency system has been reduced into a corrupt institution. It has become rotten root and branch. It has abused its power and office and as a result reformation of managing agency system became necessary by the companies amendment Act XXII of 1936. In spite of a number of restrictions and disabilities by the amending act of 1936 on the managing agency system, no substantial cure of the disease relating to this system was visible. Therefore, the Companies Act, 1956 inserted a large
number of provisions drastically reducing the powers, control and appointment of managing agents in a company. Nearly 54 sections – Sections 324 to 377 – were included with the object of regulating the managing agency system. The Companies Act, 1956 had given a long rope to the managing agency system. However they have failed to mend their ways. This led the Government to promulgate Section 324 A under the Companies Act, 1956 abolishing the managing agency system from April 3, 1970. Section 324 A transferred the management from the managing agency system to the Board of Directors. The result is old wine in the new bottle. The apparatus has been changed from the managing agency system to the Board of Directors. However, the modus operandi continued with a lesser degree. Many of the charges today can be traced to the practices adopted by the managing agency system. It is not out of the context to mention the practices of the managing agency system, which will expose the similarities of the managing agents’ practices and the current board practice.

3.6.1.1 Modus operandi for controlling the company

Under this system, the business will be controlled by a single family without contributing 51% share capital. The modus operandi is very simple. A family with some financial strength would launch a company and allot shares to its own members or close relatives. Simultaneously, the promoter, will form a managing agency firm – usually a partnership or sole proprietorship – to which the management of the new company will be entrusted under an agreement. The agreement stipulates the terms and conditions between the managed company and the managing agency firm – the promoter as well as managing agency are one and the same person. Technically speaking, thus, the managing agents did not own the company. However, they manage and virtually control it. They will take all critical and strategic decisions. The managing agents do this service for a remuneration which is also stipulated in the agreement. After this
arrangement, the company will go in for a public issue. After the issue, the original members become minority, in terms of capital contribution. However by the virtue of the managing agency contract, even if the new shareholders wish to change the management, they cannot. The management will be entrusted to the managing agents perpetually. The contract clause will be designed in such a manner.

Using the first company as the base, a managing agent will float a series of companies cutting across various sectors of the economy. He himself does not have to acquire controlling shares in all subsequent flotation: in most cases older companies under his control will make sufficient investments to ensure that the management of the later concerns did not go out of his hands. Through this process, the managing agents are able to create their own business empires without any contribution, at times. They are able to control other people’s money by virtue of this arrangement.

The companies controlled, directly or indirectly, by a particular family constituted a business house are known generally by the name of the family that controlled the managing agency. The growth of industrial houses in India during the period of 1850 to 1956 was due to the entrepreneurial initiative and the managing agency system.\(^5^2\)

With little schooling, they picked up the rudiments of general and trade education as they went along. They gathered together the small savings, and then the large profits by which their fortunes were consolidated and their economic power as entrepreneurs was acquired. They became “Captains of Industry”, and seized leadership not by right of ability, but technically speaking, they secured it as the privilege arising from the managing agency contracts.

One of the important characteristics of the system is the possible disharmony and conflict of interests between managing agents and the
shareholders. Though the possibility is present in all large industrial concerns all over the world, in India the position is somewhat different. Elsewhere, the low rate of dividend may mean creation of reserves and equally affect all parties, directors as well as shareholders. In India, however, the techniques adopted by the managing agents to make more money than the outside shareholders are unique. They manipulate their holdings so as to make more profits when things are all right and incur the least loss when things go wrong. They sell out, if they think the concern would be losing, and buy more, if they find the position to be the reverse. This practice of concerning was checked, for the first time, by the Amendment Act of 1951. Secondly, the managing agents regard their earnings from shareholdings subordinate to their earning in other capacities and fields of activity. A word about these activities or subsidiary services will not be out of place at this stage.

3.6.1.2 Remuneration of Managing Agents

The managing agents' remuneration has lent itself to great deal of criticism, and deserves, close examination, as to the different ways in which they have secured it. They have systematically exploited the weakness of the system and extracted the maximum benefits. The usual methods have been: (1) office allowances, (2) certain minimum commission payable in all circumstances, (3) commission on production or output, (4) commission on purchases and sales, (5) commission on profits, (6) miscellaneous commissions. It is interesting to note that all these several ways of remuneration are not alternative, but can be and have usually been adopted simultaneously. All of these methods were in common use in all industries.

(i) Office Allowance:

Whatever other method or methods of remuneration may be adopted, a certain fixed monthly or annual sum of money had invariably been charged by managing agents as "office allowance". This covers "head office accommodation, rent and taxes thereon, lighting, fans, managing agents' clerical establishment, share of services of dispatch, enquiry and cash departments in several instances, particularly services of senior accountant and the secretariat staff, and, in several cases, also all postages, stationery, telegram and menial staff. Office allowance accordingly is a recovery by the managing agents of their estimated out-of-pocket expenditure on behalf of the company."\(^{53}\) In so far as this was paid to cover out-of-pocket expenses incurred by the managing agents, the payment was quite justifiable. But office allowances become objectionable when they became a regular feature of additional remuneration in disguise, as had been the case in almost all companies managed by them. The allowance ranged from Rs.500 to Rs.7,000 a month and had to be paid to the managing agents even though the company bore and paid all expenses pertaining to office establishment. In some cases, office allowance increased with increase in the number of spindles and looms, and amount of capital. For example, in the case of Vasant Mills Ltd., of Coimbatore the office allowance of Rs.1,500 per month was subject to revision. Similar provisions existed in other cases. In the case of Orissa Cotton Mills Ltd., the office allowance was fixed at Rs.1,500 per month to be increased to Rs.2,500 per month if the capital exceeded Rs.20,00,000. In short, office allowance had lost its significance as a justifiable expense, since it had become a form of additional remuneration in almost every industry and constituted an unwarranted imposition on the industry.

As regards the payment of certain minimum sum, a feature common to all companies, and payable under all circumstances whether the company makes a

profit or not, no one can deny the fairness of the principle underlying it. A provision is made in the agreement that a certain minimum amount will be paid to the managing agents in case of absence or inadequacy of profits. But the trouble arises when the managing agents treat this also as additional remuneration. Now, however, a minimum sum has been expressly laid down by the Act at Rs.50,000.

(ii) Commission on Production:

The system of charging commission on output besides being objectionable as primitive. It is uneconomical and leads to inefficient working. It tends to result in sacrifice of quality for quantity; encourages over-production even where restriction of output is beneficial to the company. Since larger production means more commission to the managing agents, very often they have made enormous profits on unprofitable business. Also, the system militates against efficient management and marketing. The system has, however, been given up, Sri J.N. Tata taking a lead on discarding it and substituting for it a 10% commission on profits.

(iii) Commission on Purchases and Sales:

In several cases, managing agents charged commission on purchases of machinery, raw materials, stores and capital expenditure, in addition to commission on profits and sales. This practice was very common in Coimbatore where a commission of 1% was generally charged on purchases of Kapas, cotton or stores and 2 ½ % on capital expenditure including cost of machinery, construction, erection, and so forth. The commission could hardly be regarded as justifiable, for it was bound to lead a sacrifice of economy. In order to earn their percentage of commission, the managing agents might not make the best bargain, but on the contrary would tend to be extravagant.

The commission on sales was common in cotton mill industry. The rate was usually 3 ½ % of gross proceeds of sales. While this system gave incentive
to managing agents to work for increased sales, it did not provide the spur for efficiency in production, finance and administration for reduction of selling costs such as payments to agents, etc. It could be justified only where the managing agents had got large stakes in the concerns, as was the case in Ahmedabad; and there the system had worked successfully. There was very little to choose between these systems of remuneration, for one was as defective as the other.

(iv) Profit Sharing:

Of all the systems, that of charging commission on profits is undoubtedly the best. As already indicated, the usual rate is 10%. Of course, the managing agents do not share the losses; on the contrary, they are assured of a minimum sum in case there are no or inadequate profits. The merits of the system are obvious. It must lead to economy and efficiency and better management and marketing. All these would necessarily result in higher profits and therefore more money for managing agents. The question, however, is what should be the basis of calculating profits and commission. Should the commission be on gross or net profits? Obviously, net profit must be the basis; and Section 87C of the 1913 Act also provided for net profits. The practice in Bombay was to charge 10% commission on profits without deducting depreciation. This made the cost of managing agents’ remuneration, even when only on this basis, relatively high. For example, in the case of 30 Bombay cotton mills, the percentage of their commission to gross profits worked out to be 9.14% and after depreciation it would be 10.01%. The percentage of dividends to profits after depreciation came to 11.95%. The percentage of commission to net profits, however, worked out to be 38.8%, and that of dividends to net profits was 46.27%. This shows that the incidence of managing agents’ commission in relation to dividends was high; particularly when it is remembered that this percentage included preference dividend also. The ordinary shareholders suffered still further. In the case of 22 Ahmedabad mills, the position was still more interesting. There the incidence of commission in relation to profits after
depreciation, and the commission exceeded the amount of the dividends to shareholders by something like 125%. Similar conditions prevailed in the jute industry of Calcutta.

(v) Miscellaneous Commissions:

Besides these straightforward commissions, a fairly good number of good number of managing agents charge some other commissions. Messrs. Bird & Co., were empowered to charge extra commission on advances guaranteed by them. Messrs. Kirloskar Sons & Co., were entitled to one-third share of profits in the event of declaration of dividend of 9%. Thus, during the years 1946-48 their remuneration amounted to Rs.4,23,500 as against the shareholders' dividend which amounted to Rs.3,45,200. The managing agents got more than what all the shareholders received. Another method of getting additional income was to have one or more of the members of the managing agency firm appointed as general manager, secretary, manager, etc., on fat salaries ranging from Rs.2,000 to Rs.7,000 per month. In Zandu Pharmaceutical Works Ltd. the managing agents were entitled to a commission ranging from 12½% to 25% on profits according to the dividends distributed to shareholders. In Parry & Co. Ltd., Messrs. Parry's Holdings Ltd., had been appointed Secretaries (not managing agents, obviously to escape legal restrictions on them) and were entitled to a commission of 10% of net profits. Yet the Managing Directors of the company who were also directors and/or shareholders of Parry’s Holding Ltd., received separate remuneration amounting to about Rs.2,50,000 per year.

3.6.1.3 Hereditary Appointment

The hereditary character of ownership prevailing in most of the Indian managing agency firms, in spite of the curtailment of the period to 20 years at
one time, has often placed the management of a large number of companies in incompetent hands. The "sons" are proverbially incompetent, but it is almost impossible to remove managing agents, however incompetent they may be. They have invariably been in a position to have their agreements extended beyond the 20 years' limit, and perpetuate inefficiency, mismanagement and graft.

3.6.1.4 Multiple Directorship

The system of multi-management of industrial enterprises leads to lethargic, thoughtless and indifferent attention being given to many concerns under the supervision of a managing agent. It is an axiom that better results can be achieved by close personal attention than from large-scale management. The latter requires for its success a high degree of organising ability and driving force among those on the apex of the pyramid, or an equally high measure of reliability and intelligence among the rank and file. It will be a gross exaggeration to say that these conditions are satisfied to any marked degree in Indian business administration.

Managing Agents sold shares when the things are not going favourably and buy when the happenings are good using the inside information. In this process, at times they may not be having any stake in the concern. Under those circumstances, they will become more as parasites than as protectors of the interest of the shareholders.

Another practice has been the inter-investment of funds among companies under the same agents. This usually results in the artificial perpetuation of thoroughly insolvent concerns which should be closed down, and a loss to the shareholders in the strong concern whose funds are so transferred.

Assignment of office by the managing agents is another example of the abuse of their power and position. Trafficking on a large scale has taken place in management rights and these rights have been sold regardless of the financial standing and reputation of the purchasers and the welfare of shareholders and the staff. According to the memorandum by the Bombay Shareholders’ Association, 1949, about 50 industrial concerns involving crores of capital and reserves have changed hands, throwing the shareholders to the mercies of the purchases, most of whom utilised the common funds for their personal benefit. The predominant holdings of the managing agent, instead of being a blessing, have proved a curse.

3.6.1.5 Other Methods

The managing agents adopted innovative methods to systematically exploit the companies and their shareholders for their personal interest. Some of the methods adopted are:

(a) Managing agents or allied units were appointed as buying and selling agents, brokers, mukaddams and numerous contracts were made between managing agents and their companies in which managing agents acted as principals.

(b) The inside information which the managing agents posses is frequently misused by manipulating the market price of the shares to their advantage, for their own purchase and sale.

(c) The funds of the companies were misused or misapplied (i) by granting loans and advances of a non-trading nature to friends and business associates, (ii) by receiving large advances on current account, (iii) by making advances to or investments in sister or allied concerns for illegitimate purposes, e.g., for acquiring voting control for themselves, (iv) by getting loans from the companies by converting their firms into public limited companies, and thus financing themselves instead of financing the companies, (v) by allowing book debts due from allied
concerns to remain unrealised, and (vi) by receiving colossal amounts, sometimes aggregating to a good few lakhs, as compensation for the termination of their contracts even when the termination is brought about themselves by selling their office for a price.

(d) Powers of borrowing, investments and increase of capital have frequently been abused.

(e) Deferred shares were issued with disproportionate voting and other rights and allotted to managing agents as means of strengthening their hands still further for exploitation.

(f) Unwarranted terms and conditions were inserted in managing agency agreements.

(g) Companies have often been started with insufficient capital.

(h) The subsidiary system was frequently used to bring about changes in managing agency contracts advantageous to the managing agents concerned.

Thus it is evident that many of the poor practices of corporate sector mentioned in the earlier paragraphs, are rooted to this managing agency system. The Government unable to check the malpractice of the managing agency system by the Companies Act, 1936 and Companies Act, 1956, sealed the system and bid farewell. However, they are able to bid the farewell only to the system of managing agents and not to their practices. The corporate houses are still continuing their age old methods and practices systematically to exploit the wealth of the shareholders. The present system of managing the company through the Board of Directors is something like old wine in the new bottle. The Government is not able to curb their practices effectively.

The survey conducted by the SEBI indicated that of the total investors householders in equity instrument about 36 per cent have entered the market prior to 1991. The investors who have entered the market prior to 1970 have been exposed to the practices of managing agents. Having exposed to such
practice, the investors mind would have been conditioned or in some cases they would have thought that the post managing agency system was some what satisfactory. Perhaps the new breed of shareholders who entered the corporate sector may be more demanding.

3.6.2 Ineffective company meetings

In practice, the meetings of shareholders are no more than mere farce and are, thereof, ineffective. Although meetings of shareholders are held annually, very few shareholders really take the trouble of attending these meetings. This is partly because the shareholders live in different cities or in different countries and do not take the trouble of travelling to the place of meeting, and partly because of ignorance, bit is largely due to their indifference towards the affairs of the company. A shareholder, who regularly receives good dividends, thinks that the affairs of the company are being managed properly and hence there is no need for him to attend the annual general meeting. A shareholder who does not receive a fair dividend feels that it will be an additional wastage of money to go to the meeting. Hence, poor attendance at the shareholders’ meetings. Those who attend the meeting are usually not in a position to make an intelligent criticism of the accounts because they rarely take the trouble of reading the directors' report and studying the annual accounts and the balance sheet properly. Many of them do not possess the competence required to make an intelligent assessment of the company report and accounts.

3.6.3 Lack of unity and organisation among members

In practice, the shareholders do not form an organised group and are, therefore, not able to influence the decisions about the conduct of the business of the company. On the other hand, the top management or the inner ring is a well-organised and compact group consisting of persons who are much better informed than the general mass of shareholders. As a result, those people who
are in control of management are able to see all their proposals through in no time. An authority studied the position in England and found that those holding barely 5% of voting rights can manage the affairs of the company to their liking if the rest of the shareholders are not organised.

3.6.4 Defective system of directors' election

Though the directors are supposed to be elected by the shareholders, the 'inner ring' is able to get most of its own puppets elected as directors. This happens because the holders of the majority of the shares represented at an annual meeting of the shareholders can elect all the directors. The law requires a separate resolution for the election of each director. As a result, a shareholder with as much as 25% interest can secure representation on the Board of Directors only if those with majority control so desire. The directors are, then the elected representatives of the shareholders only in name. Actually, they are instruments of the continuation of the rule of the few at the top. Furthermore, the law requires that one-third of the directors must retire by rotation but it does not prohibit their re-election as such. Need it be said, then, that the same persons continue as directors year after year.

3.6.5 Systems of proxies

The Articles of Association of most companies permit the shareholders to nominate their representatives (Called proxies) to vote in their place. Every year before the general meeting is held, the secretary sends out the proxy form for the purpose along with the notice. Most shareholders, being indifferent to such meetings, do not attend meeting personally but authorise proxies to vote on their behalf. The existing management of the company is generally in a favourable position to secure such proxies, and as such, it is able to control the votes of a majority of proxies. If a shareholder is dissatisfied with the management, he may choose to go to the meeting, though generally he will wisely abstain from
attending the meeting. If, however, he does go and attends the general meeting, he may find an official appearing at the time of the meeting, with his pockets full of the proxies of the majority of shareholders. His voice may get drowned in the applause that is likely to follow the re-election of the same director or the approval of the management's policies. The shareholder is at a disadvantage in obtaining proxies as compared with the existing management because of the following reasons: (i) he does not generally have access to the vital company information with which he can establish the superiority of his stand, (ii) he can at best have limited resources with which he has to ask for proxies from shareholders while the management may be using company funds for the purpose, and (iii) he has to take it upon himself to prove his charge against the existing management.

3.6.6 Closure of transfer books

Generally, the transfer books of the company are closed in advance of the meeting. As a rule, only those equity shareholders are entitled to receive a notice of the general meeting whose name appear in the company's register of members. In this way, many shareholders are denied their right to vote. The practice makes the whole thing a farce; the person who has transferred his shares and is no longer interested in the company meetings throws away the notice as a useless piece of paper while the new transferee who may be eager to attend the general meeting may be told that he is not entitled to receive the notice of the company meeting since his name has yet to be recorded in the transfer register and members' register.

3.6.7 Lack of clear and complete reporting

Most companies try to paint a rosy picture for the shareholders by avoiding fullest disclosure of material information about the financial position of the company. As an instance, the operating results of various divisions may not
be reported separately to the shareholders, so that they may not get information about the less successful departments running at a loss. In this way, lack of proper reporting of accounts to public helps the existing management in getting away with a report which reveals what is beautiful and conceals what is vital.

3.6.8 Mind set of Indian Businessmen

Chanakya in his Arthasasthra observed that a businessmen is a thief but is not called so. A proverb still popular in Rajasthan states that while Jain and Bania filtered the water before drinking, had no inhibition in sucking the blood of the poor unfiltered. Unlike western and Japanese entrepreneurs many of whom had technical backgrounds, most of the Indian family entrepreneurs belonged to the trading community. They possessed an undue predilection for making money combined with contempt for technology. A strong emphasis on money making coupled with disregard for all specialisation has been a characteristic of the Indian business classes since historical times. They entered the modern day business only as traders.

The modern industrial establishment was the result of a fiat of the British Government. “The eighteenth century was characterised by a more or less total technological stagnation period in this part of the land. There is no evidence of any technological innovation of consequence perfected in India during that time”. Britain lifted the ban on technology export during 1843. This permitted the British traders to import new technology from their homeland. These factors favoured the British enterprises to start a number of ventures with European superior technology in a land which was starved of technology, leave alone the superior technology. The Indian business community did not show

57 RC.Majumdar (Ed) British Paramountcy and Indian Renaissance, Bombay, 1965.
58 Hansard’s Parliamentary Debates, III Series, Vol.71, from July 31 to August 24, 1843.
much enthusiasm in the technology upgradation, right from the beginning. Most of the companies started in that period were mostly cotton textile industry with the available technology. Notable exceptions at that time is J.N.Tata who had ventured in to new areas like steel manufacturing and the generation of electricity which require new technology and Kirloskar who had joint venture with foreign companies for new technology.

Therefore, in general, the Indian business community showed much enthusiasm in short term profit. They lack the long term vision right from the beginning. This has manifested in their day-to-day practice, which landed the business community in the court of corporate governance as accused.

Further, the ancient propensity of entrepreneurs for money making has been accentuated by the socialist policies of the government for nearly four decades. The socialist policies, whether had helped the Government in achieving their objective of equitable distribution of wealth and income or not, it did definitely help the rich people to become richer. Table 3.5 projects the economical condition of our country between two periods with reference to distribution of income.

<table>
<thead>
<tr>
<th>Institution</th>
<th>1950’s</th>
<th>1975-76</th>
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<tbody>
<tr>
<td>Estimates of World Bank along with International Labour Organisation</td>
<td>No study conducted</td>
<td>Top 20% of the population getting 49.4% Bottom 20% of the population getting 7%</td>
</tr>
<tr>
<td>Estimates of Reserve Bank of India AND Iyengar</td>
<td>Top 10% of the population getting 25% to 28% of the total income Bottom 20% of the population getting 8% to 9%</td>
<td>No study conducted</td>
</tr>
<tr>
<td>Estimates of NCAER</td>
<td>Top 10% of the population getting 35 of the total income Bottom 20% of the population getting 4% to 4.5% of the total income</td>
<td>No study conducted</td>
</tr>
</tbody>
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59 Dwijendra Tripathi and Makrand Mehta, Business Houses in Western India: A Study in
Table 3.5 lucidly illustrates that the gap between the poor and the rich people had widened. The 20% of the total population received 8 to 9 nine percent according to one study in the fifties. Whereas during 1975-76, the bottom 20 percent of the population accounted for only 7%. It is strange that the Government is not taking any step to compile such an important statistics. Perhaps the politicians might be having the apprehension of facing the public for their non-achievement. Not only did these policies protect the established business houses from competition but also created a congenial atmosphere for them to ignore the reality of their status as an agent of the shareholders.

In the early 1980s, when DCM Limited and Escorts were targeted for take-over, government agencies stopped the raiders in their tracks. That led to a perception that hostile take-over would be prevented by the government and promoters of companies could afford to keep low holdings in companies without caring for the market valuation of their companies. If they had felt threatened, they would have paid sufficient attention to the stock price and that would automatically have rendered such hostile bids difficult. It would also have generated more wealth for the shareholders. In the US, CEO, of companies are sacked if the market value dips. In India, incumbent managements are hardly ever bothered about their performance, because they are eligible for a number of benefits, whether the company is earning profits or not.

The business houses never failed to consolidate their positions and considerably increased their personal wealth but they never bothered about the shareholders. Had the management bothered about the shareholders, Hindusthan Motors would not have rolled the age old ambassador cars, which was introduced at the time of independence. Even after forty years, Hindusthan Motors never realised the need for introducing new models at least to face the competition from Maruthi. Through the mechanism of licensing, peddling with politician is more lucrative than technological upgradation.
Though steps were taken to liberalise the economy from 1991 onwards, the traditional business houses have not started reacting to face the reality. They lacked vision and wisdom. As a result, many business houses are at the juncture of devastation. With the position worsening they try to find fault with other factors, without conducting a soul search. One of the charges levied against Indian entrepreneurs was that they were operating with the technology of forties and fifties. As a result, now the business houses are at the cross roads and many companies which were darlings of the stock markets have lost their charm and hence sizeable loss to the shareholders who have invested in the shares of those companies. Had they invested in the new economy stocks they would have been benefited. It is the consequence of ignoring the technological upgradation. Hence the present researcher feels that the mental make-up of short term profits and the age old practice of free-riding on the back of poor shareholders resulted in the current state of corporate governance.

3.6.9 Xenophobia

Yesteryears’ political leaders like late Pandit Jawaharlal Nehru, economists like Mahalanobis who had crafted the Industrial Policies were suffering from Xenophobia. As a result, they restricted the entry of foreign companies and consequently, many of the multinational companies who were doing business in the pre-independence days have left the country. Hence for the small investors, the only avenue available was the existing business families for investment. Having tasted the advantages of investing in shares, the investor community continued the patronage of business families in spite of their poor corporate practices. Had the foreign companies co-existed, a bench mark would have been available for the shareholders to compare the performance. The malpractice of the business families would have been exposed to the common investors. Some foreign companies are functioning in the post independent period. The foreign companies were managed by professional managers. The
investors were able to differentiate the good and the bad. Hence the investors preferred to pay a hefty premium for the multinational companies as compared to Indian companies. The reason is that such companies performed exceedingly well and the investors have been benefited by way of very high market capitalisation, attractive dividend and frequent bonus shares.

India is a land of paradoxes. The disbelief and mistrust on the foreign companies by the rulers created an opportunity for the local business community, whom the rulers originally wanted to control. On the other hand, the investors are left with no other alternative than to invest in companies controlled by Indian business community. Hence they have tolerated the malpractice, though the shareholders were not supporting or not ignorant of that practices.

3.6.10 The ineffectiveness of employee shareholders

In the modern progressive companies, the employees are increasingly being given bonus shares and are thus being admitted to the ranks of shareholders. In companies where the number of such employee is sizeable, the existing management is able to browbeat and control them to its own advantage. This is easily done under the present system of voting according to which the votes are recorded by show of hands, and in exceptional cases through a poll. The employees will naturally side with the existing management, when they know that they are themselves at its mercy.

3.6.11 Dominance of public sector

The post independent India witnessed a new sector, public sector, in the economy, whose presence was negligible in the pre-independence period. The leaders who had chosen democratic socialism as the political system, had much faith in the public sector. The Industrial Policy Resolutions in 1948 and 1956 made India a mixed economy. These industrial policy resolutions have clearly
demarcated the scope and role of the public and private sectors. The public sector is entrusted with the responsibility of developing heavy and basic industries, social and economic infrastructure while the private sector is broadly given the right to develop consumer goods industries.

At the time of independence, almost the entire production and trade were in the hands of private sector and public sector was insignificant. After 1951, the public sector was expanded fast both by the Centre and the States and it has become significant in many fields in terms of investment, total turnover, capital formation, contribution to export effort etc. Even then the private sector has continued to be dominant in all spheres, accounting for 80 per cent of the gross domestic product and over 90 per cent of the total employment.

The Government with much fan fare launched the public sector enterprises. They boasted it as the commanding height of the economy. They described it as a model enterprise. But unfortunately, the performance of many of the public sector was pathetically poor. If at all any public sector earns profits, the concern will be enjoying monopoly powers. Many companies in the public sector incurred heavy losses and they have to be supported by budgetary allocation for the survival.

In the eyes of the common investors, the performance of the private sector was miraculous in spite of so much mis-appropriations by the promoters. The public sector happened to be a bench-mark and the private sector performance becomes stellar. If compared with the performance of the public sector, private sector performance is remarkable. The public never bothered about the practices which were condemned by the academicians and other utopians. The common investors are getting reasonable dividend apart from good amount of appreciation in their investment. Hence they tolerated and condoned such practices.

3.6.12 Political Interference
"In the past, Americans have tried to balance the power of big business with regulations enforced by big government. Today, many recognize that government regulation, while often necessary, is inherently inefficient when unaccompanied by a culture of self-policing. Given the power of corporate lobbyists, government control often equates to de facto corporate control anyway. Similarly, in India, the corporate lobby is so powerful that business community becomes defacto power centre. In the recent past, one CEO of a leading company was camping at New Delhi, when there was a power struggle to form the ministry at the Central Government, to prevent one candidate to become the prime minister of India. The support given by this business man was overt. The politicians who were at the helm of affairs have to reciprocate their well-wishers whenever they are in trouble. This nexus between the politicians and the business men is yet another factor which motivates the business community to violate the law in an unfettered fashion. One can quote a number of incidents where the politicians pulled the right strings so that the administrative machinery took a lenient view. When Swaraj Paul acquired the shares of DCM and Escorts companies shares, with the intervention of the late Prime Minister Indira Gandhi, the incumbent management was saved and the predator was not able to acquire the control of the targeted companies. Similarly, one can quote a number of incidents, where the financial institutions would have checked the erring management, but the instructions from the North Block prevented the financial institutions to act. This view is substantiated by Dr. L.C. Gupta, Member, SEBI. "In India, the pervasiveness of family control presents a far more complex problem of corporate governance than in the US or UK. The problem is made more difficult by the business-politician nexus. Such nexus has inhibited independence of action by public financial institutions,
which has to play an important role in corporate governance. But for the political interference, the corporate governance would have improved sizeably.

3.6.13 Weak Judicial System

In the most famous of all soliloquies, “the law’s delay” is placed by Shakespeare among the chief ills of human life. The administration of justice has become so obsolescent that most people regard the law as an enemy rather than as a friend. The law may not be an ass but it is certainly a snail: the operation of our legal system is not merely slow but it is susceptible to the most shameless delaying tactics and resort to the courts has become a costly lottery which takes years in the drawing. As on 31 December, 1983, more than a million matters were pending in the eighteen High Courts and more than 1,37,000 matters were pending for admission or final hearing in the Supreme Court.

In his autobiography Mahatma Gandhi observes that the law is not an “intellectual legerdemain to make black appear white and white appear black” but it is a ceaseless endeavour “to enthrone justice”. Justice delayed is justice denied. In its attempt to enthrone justice, the judicial system’s operation is a success but the patient is dead due to the inordinate delay for rendering justice. The defects of the system encouraged the citizens, including the business community as often as possible to violate the law, knowing pretty well the fact that they are violating the law. If at all the decisions of the court are unfavourable, that comes into effect after three or four decades. Till that time, they can enjoy the benefits, by the time the judgement is delivered, the necessity for them to adhere to the practice for which the trial of the case is going on for years would not have been there. Hence they do not bother about the end results. Thus weakness of the judicial system is also responsible for the present day sorry state of corporate governance in India.

“Robert Taylor is cooling his heels in an American prison. Earlier this year, a US district court ruled in favour of the Securities and Exchange Commission (SEC) in its law suit against the Better Life Club of America, a Ponzi scheme operated by Taylor. When the SEC took initial action there were no manifest problems; investors had been paid on time and more were clamouring to sign on. But the investigations painted a different picture. Explains an SEC statement: “When we filed the case, the club owed investors over $50 million, but it had only about $2.7 million in the bank.” Taylor, on the other hand, had a house and garden, a fleet of cars, and all the better things in life. Now all his assets have been frozen and handed over to the court-appointed receiver.

Harshad Mehta has a house and garden, a fleet of cars, and all the better things in life. The chief architect of the Indian securities scam of the early 1990s is still a relatively free man. Yes, there are cases galore against him and the courts have restricted his movements. But he is very much in business (the Supreme Court has ruled that he cannot be denied his right to earn a living). And, unlike Taylor, he can take his family downtown to see the occasional Ghulam or Godzilla when he wants a break.”

Delayed justice is the denied justice. This is applicable not only to the individuals who are affected but also to the society itself. As the society gets conditioned to the judicial system, the wrong doers never bothered about the punishment. Hence the citizens of the country are also conditioned for the delayed justice and as a result Government has not taken so far to expedite the delivery of justice. Action and punishment for the guilty should be speeded up so that they can be held up as cautionary examples for would-be transgressors.

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62 Nani A. Palkhivala, We, The People India The Largest Democracy. UBS Publishers' Distributors Ltd.
3.6.14 Inaction of the Government

The American economist Mr. Paul Krugman recently asked “Can America stay on top?” as it has done most of the 20th Century and asserted confidently that it will retain its place as first among equals for many years to come. America will not dominate the world economy the way it used to, not because it is doing something wrong, but because many other countries are also doing something right.

If the same question is asked with reference to Indian Economy, what will be the answer? Can it be possible to proudly assert that “India will be joining the league of the countries that are doing something right”? The answer will be definitely a negative one. The reason is that, our rulers are not managing the economy, they are managing the crisis only. We, the Indians are accustomed to Crisis Management. Our rulers are most often reactive rather than proactive. Crisis management is the style of functioning of all the parties who have occupied the power till date, with occasional exceptions. Often their action is a kind of knee jerk reaction.

The modus operandi in an administration, whether at the micro or macro level, should be that whenever the old policies are not delivering the results or misfiring, action shall be taken to reverse the gear or pursue new measures to address the problem. Unfortunately this is not happening in India. The policy makers will be compelled to react only when a crisis engulfs the economy. The crisis may be the tip of an iceberg. Then only the rulers will be compelled to think of the symptoms and diffusing the crisis by addressing the symptoms and not the problem. The crisis will be diffused by some adhoc measures. The system will be allowed to continue with the adhoc decisions taken, till another

crisis erupts. Till such time, there will not be any review of the results of the adhoc measures taken earlier, even if the situation warrants a sea change. Another crisis is needed to attract the attention of our rulers. The vicious cycle is going on. Today's problems are yesterday's solutions.

In the post-independence era, one can cite a few policy measures taken consciously to charter our economy towards the desired destiny. In the Nehruvian era, the Five Year Planning programmes and the Industrial Policies were the best examples of the conscious and calculated decisions. In the post Nehruvian era, political ambitions dominated economical issues. Till late sixties, the economical issues dominated the economical decisions and as a result Mahalanobis Committee, Dutt Committee and a host of other committees for the review and working of the policy. Such review resulted in the MRTP Act and MRTP Commission. Thereafter, the policy level decisions taken were purely out of either political compulsion or reaction out of the prevailing economical contingencies. Even such reactions were only adhoc. The only exception to the rule is the LPG reforms which were rather thrust upon us by the World Bank and IMF and not initiated by us. Simply it is endorsed by the then rulers. The Balance of Payment crisis compelled the Congress party to reverse the nation from the Licence Raj Model to Market-Driven Economy Model. This decision is a major decision like that of the decisions pertaining to Industrial Policy Resolutions and Five Year Plans Strategy. However, former is made from within (by our rulers) and the latter (LPG) from outside (by our creditors or financiers).

Now the pertinent question is how the Government machinery's contribution led to the present state of Corporate Governance. Is it an economy of laissez-faire policy, without any control? No. It is a controlled economy. In fact, that is one of the usual charge levelled against the country by the western nation. The IMF and the World Bank's prescription for the 1991 Balance of Payment crisis was liberalisation. Hence the Government has so far been
actively engaged in the prescription of policies and framing rules and regulations for regulating the activities of companies. In fact the Companies Act, 1956 is one of the lengthiest piece of legislation with 658 sections with so many sub-sections and sub-clauses. The Companies Act, 1956 is amended very frequently to reflect the changing situation. The reaction of the Government once led to the passing of an amendment in 1969 to abolish the managing agency system. Inspite of such active involvement the present state of corporate governance is highly unsatisfactory. The Government’s mode of reaction is the reason for this for this state of affairs. Our rulers are most often reactive rather than proactive. Hence the administrative machinery is susceptible for break-down. The frequent occurrence of scams and fiascos in the stock exchanges is an indicator of the weakness of the system.

The system of corporate governance in India operates in an administered environment. This environment provides ample scope for discretion and exceptions in individual cases. Administrative control is seen as arbitrary and enforcement as poor, as many recent scams have demonstrated. Though India has a legal structure for handling disputes, high incentives for those who overcome, by whatever means, the regulatory constraints and the incidence of high taxes.  

The administrative machinery for the corporate sector consists of three important agencies, viz., SEBI, Department of Company Affairs and Ministry of Finance. Absence of co-ordination between these agencies leaves a number of loop-holes in the system through which the raiders are breaking the system, which at times halt the entire system as occurred in Harshad Mehta’s episode. The post-LPG era witnessed Harshad Mehta episode, CRB scandal and M.S.Shoes scam. The regular occurrence of such episodes clearly highlights the systemic failure. As a result even the law abiding citizens in the corporate sector
are tempted to violate the rules and regulations and twisting the existing the laws to suit their action. The classic citation for twisting the laws to suit their action is the Insider Trading episode involving Hindusthan Lever Limited and SEBI.

3.6.15 Fruits of Corporate Governance

At the same time, a handful of business families appear to have developed an uncanny ability to weather every storm that threatens the corporate landscape. By some strange alchemy, they also manage to pass on this invaluable quality from father to son so that, generation after generation, that business house not only endures, but also thrives. The main ingredient of the strange alchemy is trusting and be trusted by the shareholders.

The Tatas have ruled over industrial India for over 150 years now. Some call the Rs 37,500-crore group a dinosaur, but it has managed to rejuvenate itself several times. At present, 83-plus companies are controlled from Bombay House, a nondescript building tucked away in a quiet by-lane. Is it mere coincidence that several Tata companies that were promoted in the early 1900s are still around? The answer is their respect for the shareholders.

When the entire Indian business community was utilising the managing agency system to loot the shareholders wealth during the 19\textsuperscript{th} century, J.N.Tata preferred to report to the shareholders directly. He avoided the managing agency system. However the reception of the system was not encouraging. Therefore, he was compelled once again switch over to managing agency system. It was a pioneer attempt on the part of the company suo moto to avoid the managing agency system. In fact the Government with much fan fare had restricted some 100 years afterwards and abolished the managing agency system once for all during 1970. The realisation dawned to the Government after nearly

\textsuperscript{65} KRS Murthy, Corporate Governance Worldwide, Management Review, Vol.8 No.3 & 4, July-September 1996, October-December 1996
a century was realised by the visionary J.N. Tata and hence preferred to report directly to the shareholders through the Board of Directors. Another event can also be cited which vindicates the researchers' stand that the TATA house respected shareholders, as compared to other business houses in India. At a time when all the managing agency system charged commission on purchases and sales simultaneously, which is referred to in the preceding pages, J.N.Tata changed for the first time in India and entered into a contract to receive the commission on profits only. The respect the Tata house had for the shareholders was reciprocated by the shareholders in the form of good response to the public issue whenever they approach the market. When the Tata-Timken Company approached the market it received heavy over-subscription. The respect shown by the Tata group is instrumental in converting the individual Tata business into a Tata Group, which is invariably topping the list of the richest group in the country.

Perhaps there may be some charges. However, the overall score may be far better than the rest. That is why such a conglomerate is able to survive for a long period. Had they neglected the corporate governance principles, they would not have survived. Recently, the Tata House has created a mechanism for monitoring the companies under their staple. While many companies in India are least bothered about the sick companies under the control, Tata's have taken steps to revive a number of companies under their staple which are not well performing for a pretty long time.

History tells us that the Birlas have been big businessman for at least five generations now; Kumar Mangalam Birla, the latest icon of the clan, is the great-great-great grandson of Shiv Narain Birla, the group's founder, who started the innings during 1918.66 The Darwinian principle, i.e., survival of the fittest gives a clean chit for the Birla Group companies also. They have also amply rewarded the shareholders. Whenever an opportunity is available, they utilised the
opportunity and racked money. Cement is in short supply during seventies and eighties. Sensing the opportunity almost all the Birla companies entered the cement business, though the business may be unrelated to their main activity. In the process, the shareholders have been duly rewarded. The concept of core competence is a new mantra in the Indian context. Now the Birlas are reacting by quitting away from the unrelated business. As in the case of Tata's, Birla's are also not free from charges.

In 1958, Dhirubai Ambani, the son of a school master, worked as a petrol bunk attendant with Burma Shell Aden. In 1966, the Reliance Commercial Corporation was promoted into a private limited company with a capital of 15 lakhs. It is now a manufacturing company of knitted fabrics. Eleven years later, in 1977, the company's first equity issue of Rs.3 crores was oversubscribed four times, a news in those days. Within a short span of 12 years, in the year 1989, the Reliance Industries Ltd was firmly entrenched as the third largest business house in India, just behind the well established houses of Tatas and Birlas, with assets of Rs. 4,310 crores and Rs. 19,346 crores in 1997 with a turnover of Rs. 8,468.37 crores during 1997. The phenomenal rise can be attributed to the respect he had shown for the business and the shareholders. One of the main charges of the Indian entrepreneurs is that they are least bothered about the technology upgradation. Contrary to the general business community's ideology, the Reliance Industries Ltd believed in the technology. Even before going to the public, during 1975 a World Bank which visited India to assess the textile industry noted: "Judged in relation to standards in developed countries, many of the mills have been off the scale. Only one mill, recently established, concentrating on man-made filament yarns and fabrics, could be described as excellent by developed country standards". 67 The only one mill was nothing but the Reliance Industries Limited. Even this report did not faze the complacent of the yesteryears Maharajas of Indian businesses.

The Indian investors till the arrival of Ambani were conditioned to believe that wealth could only flow upstream to the rich. Indeed, the World Bank’s certificate helped Reliance Industries Ltd to mobilise the funds for its first issue. However, with the regular bonuses, right issues, dividends and high market prices, he proved that the wealth could also flow from top to bottom, rather than bottom to top always. In 1979, the convertible debenture was made popular in India by Reliance Industries Limited, which was a type of financial instrument in the text books only till then. The rest was history. The first investor-friendly company in India, which kept the investors happy always. Ambani created a number of records, like the largest issue of convertible debentures in India to the tune of Rs.820 crores. Now around 4 million shareholders are in the Reliance Industries Ltd family, the second largest shareholders family in the world. This is not a thing which can be achieved easily, which even the business houses with a history of more than a century could not accomplish. The secret behind the outstanding success is the respect the Ambanis have for the shareholders.

However before one attempts to pass on the judgement, the overall position should be considered. A holistic approach is needed. Judging from that angle, we can give a clean chit for the Tatas, Birlas and the Reliance Industries. There may be some lapses. Judged by their overall achievement one can deliver the above judgement. The mortality rate of the companies in these business houses is another fitting testimonial for evaluating their score for their better corporate governance practices.

3.7 CHANGING SCENARIO

However, the picture is different now. The world over the promoters have lost control. Promoters have to change and prepare for tomorrow. Change will not be easy, but change they will have to. They should remember that in the

United States, shareholders and non-executive directors got together to throw out the bosses at IBM, Westinghouse and Kodak. Even in India once the shareholders in the annual general meeting removed all the existing board members, in Ralliwolf Ltd.68

The Indian business community still has not realised the importance of corporate governance. In a Business Standard-ORG MARG survey of leading CEOs for various problems, at a spontaneous level, the respondents were asked to enumerate three most important events that could affect the Indian economy and business environment over the next 25 years. WTO agreement received the maximum attraction and the score obtained by WTO is 14.8 per cent, followed by Liberalisation programmes with a score of 12.6 per cent. The least score (1.1) is awarded to corporate governance. This shows the importance given by our CEOs to the corporate governance issues. They never consider it as a problem, because the environment is conducive for their approach.69 Table 3.6 presents the scoring of different issues in the above-mentioned survey.

"Those companies where the promoters continue to believe that they own the company and everything that they do is in their own interest are in trouble", according to the Managing Director of an automobile company. "The success of a business will depend on professional management. Gone are the days when an inefficient promoter could also do well," a promoter chairman observed. "Family must be restricted to boards, rather than management. But admitting you are not competent isn't easy" Bajaj Auto CEO Rahul Bajaj commented on the way Indian business families need to reinvent themselves.70

Hence promoters who seek to survive and prosper would do well to remember that the main aim of their business is to maximise shareholder returns.

No promoter should be allowed to improve his position at the expense of the shareholders. Good corporate governance improves the capital market, the willingness of the people to save and invest in equity and thus improve the whole economy. The attempt of the promoters to increase control should attract the take over code provisions. According to SEBI guidelines, the promoters' contribution should be 20% or 25% of the issued capital going up to 50% in the case of premium issues. The balance amount is to be brought in by the public in the form of share capital and by financial institutions in the form of term loans. With so much of stakes of outsiders, it is but natural that promoter should switch over to better corporate governance.  

Table 3.6

The Most Important Issues that could affect the Indian Economy and Business Environment over the next 25 years

<table>
<thead>
<tr>
<th>RANK</th>
<th>RANK (%)</th>
</tr>
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<tbody>
<tr>
<td>1. WTO Agreement</td>
<td>14.8</td>
</tr>
<tr>
<td>2. Liberalisation &amp; Reforms</td>
<td>12.6</td>
</tr>
<tr>
<td>3. IT / E-Commerce</td>
<td>9.8</td>
</tr>
<tr>
<td>4. Privatisation of Government undertakings</td>
<td>9.3</td>
</tr>
<tr>
<td>5. Infrastructure development/privatisation</td>
<td>9.3</td>
</tr>
<tr>
<td>6. Financial Imbalance in budget / Subsidies / Tax reforms</td>
<td>8.2</td>
</tr>
<tr>
<td>7. Capital account convertibility</td>
<td>6.6</td>
</tr>
<tr>
<td>8. Social development - Education / women / population</td>
<td>6.0</td>
</tr>
<tr>
<td>9. Defence issues - Pakistan / CTBT / Arms race</td>
<td>5.5</td>
</tr>
<tr>
<td>10. Entry of private sector in insurance / telecom</td>
<td>4.9</td>
</tr>
<tr>
<td>11. Reforming the Govt. / Judiciary</td>
<td>3.8</td>
</tr>
<tr>
<td>12. Revision of labour laws</td>
<td>3.3</td>
</tr>
<tr>
<td>13. Foreign portfolio investment</td>
<td>2.7</td>
</tr>
<tr>
<td>14. Political Climate</td>
<td>2.2</td>
</tr>
<tr>
<td>15. Corporate governance</td>
<td>1.1</td>
</tr>
</tbody>
</table>


Today, Corporate India is on the threshold of entering 21st century with the goal to emerge an economic power. There has been a paradigm shift in the last five years and many of the State controls have been lifted to move towards a free market regime. The process of reform continues unabated and attempts are

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being made towards full convertibility of rupee with replacement of Foreign Exchange Regulations Act with Foreign Exchange Management Act. Clearly the focus of Indian Government is changing from ‘regulation’ to ‘management’.

### 3.8 GOVERNMENT AND CORPORATE GOVERNANCE

The company is created by a charter of the Government. Therefore, it is the duty of the Government to regulate the affairs of the company in such a way, that the welfare of the investors and the public is protected. If the objectives of the company law are traced, it is the protection of the gullible and innocent investors. The objectives of the first Companies Act, the Bubbles Act, was indeed to protect the investors. Therefore, it is the duty of the Government to see to that the companies are governed in the best interest of the society, at least from the shareholders’ point of view.

The Government regulates the corporate sector in India through a network of agencies. The network consists of Ministry of Finance, Department of Company Affairs, Company Law Board, Securities Exchange Board of India and Stock Exchanges. In addition to the above agencies, agency like Reserve Bank of India enters the scene, if the business of the company happens to be a banking business. A number of legislation is enacted to regulate the companies. The principal regulation in this regard is the Companies Act, 1956.

The Companies Act, 1956 is the largest statute of our country with 658 main sections with a number of sub-sections and sub-clauses along with XV schedules, supplemented with good number of periodic circulars, rules, notifications and guidelines. The need for such a mammoth legislation is to ensure safety of investors at large. Safety of investors has been ensured by laying down detailed guidelines for operating the management of the affairs of a company, empowering the shareholders, establishing the public Office of Registrar to disseminate information about the affairs of the company, fixing
liabilities of the management and prescribing penalties etc, to deter the non compliance.

In spite of such detailed legislation, one can observe that desired things cannot be achieved simply through legislation. Added to the fuel is the multiplicity of agencies in the corporate arena. Absence of co-ordination in this area encouraged the promoters to violate the law and to circumvent the provisions for their personal gains. The result of which is ‘Scam Cycles”. As trade cycles appear in the economic front with some regularity, scam cycle also started appearing in the corporate scene with much more regularity, than the trade cycles. The corrupt politicians, weak minded bureaucrats and rogue entrepreneurs proved that exploitation of the opportunities is the right way of making (wrong) profits.

Gone are the days when statutes were respected, and rule-books not jeered at. Once public servants were proud enough to resign even if their subordinates were caught in the wrong. But things started changing when new laws were made to protect the powerful. First, it was ministers who could not be prosecuted without the consent of the assembly of the representatives of people. Then it was people who were close to those who were powerful. The trickle down effect began. Corruption was bound to spread. Power corrupts power and absolute power corrupts absolutely. Finally, flouting the law becomes a convention, rather than an exception. The misuse of machinery becomes so rampant, that turning a blind eye to such happenings is often the best solution in order to survive. It is only when a crisis takes place, that policy makers decide do shed their inertia, and believe that it is time to clean the stables.

3.9 SECURITIES EXCHANGES BOARD OF INDIA

The rotten situation compelled the Government to find ways and means to clean the stables. Securities and Exchange Board of India was formed.
Historically, most issues relating to shareholders' rights were governed by company law. Over the last few decades, in many countries, the responsibility for protection of investors has shifted to the securities law and the securities regulators at least in case of large listed companies. The growth of Indian Stock Market necessitated the creation of an independent regulatory agency. The Securities and Exchange Board of India (SEBI) was set up as an administrative body in April 1988. It was given statutory status on 30-12-92 by passing of SEBI ordinance in the parliament. The basic purpose of establishing SEBI is to protect the interest of investors in securities and to promote, develop and regulate the securities market and the matters connected therewith.

Instead, these evolve due to the catalytic role played by the more progressive elements within the corporate sector and, thus, enhance corporate law.

### 3.9.1 Objectives

The SEBI was given birth with the following objectives:

- To promote fair dealings by the issuers of securities and ensure a market place to raise funds at a low cost.
- To protect investors and safeguard their rights and interests.
- To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc., with a view to making them competitive and professional.

### 3.9.2 Constitution of SEBI

Section 4 of the Act lays down the constitution of the management of SEBI. The Board of members of SEBI shall consist of a Chairman, two members from amongst the officials of the Ministries of the Central Government dealing with Finance and Law, one member from amongst the officials of the Reserve
Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934, two other members to be appointed by the Central Government, who shall be professionals and inter-alia have experience or special knowledge relating to securities market.

Section 17 of the Act empowers the Central Government to supersede SEBI, if on account of grave emergency, SEBI is unable to discharge the functions and duties under any provisions of the Act, or SEBI persistently defaults in complying with any direction issued by the Central Government under the Act, or in the discharge of its functions and duties under the Act and as a result of such default, the financial position of SEBI or its administration has deteriorated, or in public interest.

3.9.3 Salient Features of SEBI Act 1992

- The SEBI shall be a body corporate with perpetual succession and a common seal.
- The head office of the Board shall be at Mumbai and branch offices at other places in India.
- The chairman and five members of the board are appointed by the central government.
- It is the primary duty of the Board to protect the interest of the investors in securities and to promote the development of and to regulate the securities market.
- Compulsory registration and issue of registration certificates to the intermediaries of securities market.
- Central Government shall provide finance and also make appropriate grants to the Board.
- Central Government has powers to issue directions to the Board on the policy matters and shall supercede the board in the event of default by the board.
3.9.4 Functions

The following functions have been entrusted to the Board:

- Regulating the business in stock exchanges.
- Registering and regulating the working of intermediaries like stock brokers, sub brokers, underwriters, etc.
- Registering and regulating the working of collective investment schemes including mutual funds.
- Prohibiting fraudulent and unfair trade practices relating to securities market.
- Promoting investors awareness and training of intermediaries of securities market.
- Prohibiting insider trading in securities.
- Regulation of substantial acquisition of shares and take over of companies.
- Inspection, enquiry and audit of stock exchanges and other organisations in securities market.
- Exercise of such powers as may be delegated to it by the central Government under Securities Contract Regulation Act 1956.

3.9.5 Powers of SEBI

Section 11 (1) of Act casts upon SEBI the duty to protect the interests of investors in securities and to promote the development of and to regulate the securities market through appropriate measures. These measures provide for:

(a) regulating the business in stock exchanges and any other securities market,
(b) registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities market in any manner,
(c) registering and regulating the working of collective investment schemes, including mutual funds,
(d) promoting and regulating self-regulatory organisations,
(e) prohibiting fraudulent and unfair trade practices in securities market,
(f) promoting investor education and training of intermediaries in securities market,
(g) prohibiting insider trading in securities,
(h) regulating substantial acquisition of shares and take-over of companies,
(i) Calling for information from, undertaking inspection, conducting enquiries and audits of the stock exchanges and intermediaries and self-regulatory organisations in the securities market,
(j) performing such functions and exercising such powers under the provisions of the capital issues (Control) Act, 1947, (subsequently repealed) and the Securities Contracts (Regulations) Act, 1956, as may be delegated to it by the Central Government,
(k) levying fees or other charges for carrying out the purposes of Section 11 of the act,
(l) conducting research for the above purpose,
(m) performing such other functions as may be prescribed by the Government.

3.9.6 Working of SEBI

SEBI has been carrying out its duties successfully. Efforts of SEBI to protect investors are varied and unlimited. It has issued guidelines for disclosure and investor protection. These are to be followed by the companies before making a public issue, bonus issue, right issue and issue of debentures.

The guidelines on mutual funds formulated by the Government requires that all mutual funds should be registered with SEBI. It is required that all security exchanges must submit a detailed report on the volume of turnover in the securities and the outstanding position of transaction in securities.
SEBI is taking active steps with respect to investor protection by identifying the companies with high degree of investors’ companies and directing them to redress investors’ grievances promptly. A series of advertisements are also being issued by SEBI to educate the investors. Thus we can confidently say that establishment of SEBI is a welcome move in the history of stock dealings in India.

3.9.7 Steps taken by SEBI

The following steps are taken by SEBI to tone up corporate governance system.

3.9.7.1 Disclosure

The SEBI’s mantra with reference to corporate governance is ‘disclose or desist’. They are of strong opinion that corporate sector should realise that the investor, big or small, has the right to all know all the details about their company. The contribution of SEBI in this regard is remarkable. Companies which were disclosing once in a year, about their performance, now are compelled to disclose their unaudited quarterly results as well as audited half-yearly results.

Adequate financial reporting and disclosure are the corner stones of good corporate governance. These demand the existence and implementation of proper accounting standards and disclosure requirements. A separate committee appointed by SEBI under the Chairmanship of Shri Y.H. Malegam (who is also a member of this Committee) is examining these issues on a continuing basis. The following disclosure patterns are the result of the ardent efforts of SEBI:

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72 Birla Committee Report
strengthening of disclosure norms for Initial Public Offers following the recommendations of the Committee set up by SEBI under the Chairmanship of Shri Y H Malegam;

providing information in directors’ reports for utilisation of funds and variation between projected and actual use of funds according to the requirements of the Companies Act; inclusion of cash flow and funds flow statement in annual reports;

declaration of quarterly results;

mandatory appointment of compliance officer for monitoring the share transfer process and ensuring compliance with various rules and regulations;

timely disclosure of material and price sensitive information including details of all material events having a bearing on the performance of the company;

despatch of one copy of complete balance sheet to every household and abridged balance sheet to all shareholders;

issue of guidelines for preferential allotment at market related prices; and

issue of regulations providing for a fair and transparent framework for takeovers and substantial acquisitions.

Cash Flow Statements to be annexed to annual accounts.

The company shall forward unabridged annual financial statements.

Statement showing projected and actual utilisation of funds. If there are material variations between the actual and projections, the company shall furnish an explanation thereof in the advertisement. This comparison must also be provided in the Director’s Report.

New guidelines that prohibited preferential allotments at a price lower than the average market price during the preceding six months.

3.9.7.2 Take-over Code

Liberalisation has opened the floodgates of restructuring in Corporate India like never before. Mergers and acquisitions have become the order of the
day. And as companies exit unrelated business and focus on core competencies, a leaner, meaner and more competitive Corporate India is emerging. Corporate dons are resorting to take-over mechanism for acquisitions. As a result SEBI has enacted a legislation to streamline the take-over mechanism, Take-over Regulations 1997. The Take-over Regulations 1997 seem to be developing through fire-fighting measures. As each new crisis arises, the law is amended to cover those loop-holes which arose in the crisis.

3.9.7.3 Insider Trading

Insider trading is rampant in the stock exchanges of our country. Dealing in a company’s securities on the basis of confidential information relating to the company is one of the main drivers of speculative activity and price volatility. Several stock brokers, who execute such transactions for insider clients, also trade on their own account on the basis of such information. Worse, such information is often passed to other select clients so that they too can make a quick killing. The ordinary investor of course, remains outside this privileged loop.

Clearly, insider trading involves taking convert and unfair advantage of access to confidential information and constitutes a violation of fiduciary responsibilities. It generates potential conflicts of interest in which the company’s best interests take a back seat to the insider self-interest. But, its most damaging effect may well bring the erosion of public confidence in the capital markets.

Though investor protection constitutes a part of the SEBI’s mandate, insider trading has flourished in a regulatory vacuum. Disclosure standards are extremely poor making detection difficult. This has been compounded by the lack of provisions in the SEBI Act relating to “powers of investigation.” Unlike the powers of search accorded to the authorities in other economic legislation, the powers conferred on the inspectors and on the investigators, appointed by the
SEBI, do not have the necessary statutory backing. As far back as 1985, the Government of India had proposed an amendment to the listing agreement that specifically dealt with insider trading. That proposal however, was quietly shelved.

All new companies shall be required to maintain on a continuous basis the non-promoter holding, at the same level as applicable at the point of entry (10 per cent or 25 per cent). For existing listed companies, where the non-promoter holdings is less than the applicable limit at the point of entry, the companies will be given time up to one-year to raise the level of non-promoter holding to at least 10 per cent.

Currently, companies disclose details of their top shareholders only once a year. Often Indian investors have not known the exact shareholding of the dominant shareholders of a company and changes if any to this list. Sebi wants companies to disclose the shareholding of the promoter or promoter group, persons acting in concert, dominant shareholders, those with more than 5 per cent shareholding and other broader categories of investors, like institutions – domestic and foreign – and the public. Sebi has been working on an electronic filing and data retrieval system on the lines of the Electronic Data Gathering, Analysis and Retrieval System (Edgar), created by the United States’ Securities and Exchange Commission (SEC).

3.9.7.4 Corporate Governance Code

"Important sections of the corporate sector too have been indulging in some honest soul-searching. On 9 September, 1996 the Confederation of Indian Industry (CII) hosted a closed-door meeting in New Delhi from 12.15 to 2.15. Among its 37 participants were finance secretary Montek Singh Ahluwalia, Industrial Credit & Investment Corp of India (ICICI) chairman Narayanan Vaghul, adviser to the finance minister Jairam Ramesh, Mahindra & Mahindra (M&M) deputy managing director Anand Mahindra, Hindustan Lever Chairman
Keki Dadiseth, IDBI chairman S.H. Khan, UTI chairman Jagdish Capoor, Maruti Udyog managing director R.C. Bhargava, former industry secretary Mantosh Sondhi and CII director-general Tarun Das. The topic of discussion: corporate governance.

The meeting had no formal agenda, and is described by one participant as a “brain-storming session.” Sources say that it was meant to provide inputs for a CII task force that had been set up earlier on corporate governance, headed by Rahul Bajaj. Several issues were discussed, including the roles of company boards and of the FIs. Says one participant: “Who will govern the governors?” It was also suggested that an Indian version of the Cadbury committee be set up.”

CII, with the help of a world renowned consultant, released its own version of ‘Code of Corporate Governance’ in the year 1997. The CII code was voluntary one on the initiative of the business community. There are lot of apprehensions about the implementation of the code because no body need not have to search for instances where promoters have benefited themselves by taking advantages of loop-holes in the company law. In general business community in India respect laws more in violation than in adherence. There are many such cases involving large business groups. Therefore, it is widely felt that ‘self-regulation’ would not work in our country.

Hence, SEBI continued the task of giving legal sanctity to the corporate governance code. With the idea of roping in the business community, in this exercise, SEBI constituted a committee on May 7, 1999 under the Chairmanship of Kumar Mangalam Birla to draft a code on Corporate Governance. It is a 19 member committee, people drawn from different segments of the society, including one from investor association. The terms of the reference are as follows:

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(a) to suggest suitable amendments to the listing agreement executed by the stock exchanges with the companies and any other measures to improve the standards of corporate governance in the listed companies, in areas such as continuous disclosure of material information, both financial and non-financial, manner and frequency of such disclosures, responsibilities of independent and outside directors;
(b) to draft a code of corporate best practices; and
(c) to suggest safeguards to be instituted within the companies to deal with insider information and insider trading.

The draft code suggested by the Kumar Mangalam Committee was ratified by the SEBI and made it obligatory for all the listed companies with a paid-up share capital of over and above 3 crores to comply with the code. However, it is a time-bound programme for the companies to adhere to the code. The Compliance Time Table requires that BSE A Group companies and CNX Nifty companies comply with the Corporate Governance code within the financial year 2000-2001; listed companies with a paid-up capital of Rs.10 crores and above or net worth of Rs.25 crores and above any time in the history of the company by 2001-2002 and all other entities having paid-up capital of Rs.3 crores and above by 2002-2003.74

3.10 CONCLUSION

This chapter attempted to trace the evolution of companies in India. Its growth in the post-independent India has been highlighted. The profile of Indian business has been elaborated. The issue of corporate governance with reference to companies registered in India has also been thoroughly discussed. An attempt was made to identify the reasons for the poor corporate governance practices. The role of Government in the issue of corporate governance has been discussed.

In its attempt to strengthen the corporate governance mechanism, the Government, created SEBI. SEBI, on its part has taken a number of steps to strengthen the corporate governance mechanism.