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Corporate governance in India in the context of the Companies Bill 2009: Part 2: Evaluation

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***I.C.C.L.R. 83** Introduction

Part 1 of this article reviewed the recent evolution of corporate governance in India through the reports of a series of committees that have considered the issue over the past decade. Given that the past year has witnessed both a major corporate governance scandal and the reintroduction to Parliament of an unchanged version of the Companies Bill, this second part considers two questions: first, whether the jurisdictions from which those committees borrowed corporate governance concepts --principally the United Kingdom and the United States--can still be regarded as reliable sources given their own recent problems; and, secondly, whether the extent to which the various committees and the parliamentary draftsmen have sought to accommodate the particularities of the Indian context will be sufficient to avoid similar problems as well as to deal with any shortcomings revealed by the Satyam scandal, which came to light in India in January 2009.

The continued reliability of UK and US corporate governance concepts

While the Satyam scandal has been a major blow to the Indian corporate world, which surely felt that the developments in corporate governance during the last decade had taken the country far beyond the stock market scandals that were a feature of the 1990s, it might also be suggested that on a global scale the Satyam case is by no means the most pressing corporate governance problem. In the context of the global financial crisis it is certainly true that the losses involved pale into insignificance.1 It may also be suggested, however, that those broader problems impact directly on the Indian context given that they may indicate shortcomings in the governance arrangements in the very jurisdictions that India looked to for inspiration in developing its own approach.

The United Kingdom

Looking first at the United Kingdom, what is very striking about the most egregious failures of the financial crisis is the fact that the banks involved are all listed companies that were subject to the provisions of the Combined Code at the relevant time.2 It may immediately be objected that the financial crisis reveals more about shortcomings in banking regulation than it does about problems with corporate governance arrangements.3 While there are undoubtedly questions to be asked about banking regulation (or perhaps more correctly about the way in which the regulations were implemented) and while the Combined Code is still regarded as "highly successful",4 it would nevertheless be disingenuous to suggest that corporate governance is not also implicated. A detailed review of the Combined Code in the context of the crisis is beyond the scope of this article, but it is possible fairly readily to point to the most pressing questions raised by recent events.

It is acknowledged that the banks at the heart of the crisis in the United Kingdom demonstrated serious shortcomings with respect to their risk management. While the Turner Review accepted that not all of the problems could have been ***I.C.C.L.R. 84** dealt with at the level of individual firms, "there were also many cases where internal risk management was ineffective and where boards failed adequately to identify and constrain

excessive risk taking".[5] This is surprising from a corporate governance perspective given the prominence accorded this issue in the Combined Code. Among the supporting principles listed under Principle A.1 may be found the following: "The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed"; and non-executive directors "should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible".

Furthermore, code provision C.2.1 states that the board's annual review of the effectiveness of internal control system should include "risk management systems", while code provision C.3.2 lists among the responsibilities of the audit committee:

"… to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems".

In short, the board, NEDs and the audit committee are all given explicit responsibilities in relation to risk management. And yet the Turner Review found that there were questions as to the "technical skills and experience" especially of NEDs on bank boards as well as about their willingness to challenge CEOs.[6]

It must be recalled, of course, that the Combined Code is not mandatory, but rather is characterised by a "comply or explain" approach. In other words, a company is not required to follow the principles and code provisions slavishly, but if it chooses to deviate from them it must explain why it is doing so and what it is doing instead.[7] The aim is to ensure that "shareholders" are provided with "a clear and comprehensive picture of a company's governance arrangements in relation to the Code as a criterion of good practice".[8] Thus the important point to understand in relation to "comply or explain" is precisely who the explanation is addressed to. Looking at the terms of the Listing Rules, it is clear that the regulator, the FSA, is only concerned to ensure that the requisite compliance statements have been made[9] --it is not interested in the detailed *content* of those statements, which is a matter only for the shareholders, and more specifically the institutional investors.[10] Turner indicates, however, that the extent to which the latter were able to constrain risky strategies is also in doubt.[11]

Accordingly, in assessing the performance of corporate governance in the United Kingdom in the aftermath of the financial crisis, there would certainly appear to be serious questions to be asked about the role of boards, NEDs, audit committees and institutional shareholders, but more particularly about the very nature of the whole "comply or explain" approach itself. The very bodies that were expected to have an economic self-interest in monitoring the corporate governance of the companies in which they had a significant shareholding appear not to have behaved in the way that the model assumed. While more detailed analysis of the role of institutional investors during the financial crisis remains to be carried out, the recent Walker Report into corporate governance in the banks involved suggests that "there appears to have been a widespread acquiescence by institutional investors and the market in the gearing up of banks' balance sheets as a means of boosting returns on equity"[12] and there is certainly evidence from the immediately preceding period which suggests that the "comply or explain" approach was failing.

MacNeil and Li, for example, found significant non-compliance in relation to the Code as a whole.[13] While that might be surprising given the Code's expectation that companies will comply with its principles "most of the time", nevertheless it is accepted that deviation may be justified "in particular circumstances" provided that a company has reviewed "each provision carefully" and given "a considered explanation" in the event of any departure from the Code.[14] McNeil and Li discovered, however, that the reasons for non-compliance offered in disclosure ***I.C.C.L.R. 85** statements were often "brief and uninformative", raising "serious doubt" about whether institutional investors could actually carry out the sort of monitoring assumed by the Code.[15] Again, this need not be a particular concern insofar as the model underlying the Code would predict that where there was both non-compliance and inadequate explanation institutional investors would react in the ultimate by divesting themselves of shares in the companies concerned, as that would be

in their economic self-interest. This was certainly the received wisdom.16 McNeil and Li's findings, however, were quite different. Speculating that institutional investors might be assessing the risks associated with non-compliance and inadequate explanation on a different metric, they found in fact that acceptance of non-compliance was positively correlated with strong share-price performance.17 Put another way, institutional investors were effectively replacing the expected "comply or *explain* " approach with a "comply or *perform* " approach.18 The extraordinary short-sightedness of this way of assessing corporate governance is all too obvious. Were there any stronger performers in the market in the period up to mid-2007 than the very organisations that fell so spectacularly shortly thereafter?19

In so far, then, as the Indian approach to corporate governance has borrowed from the United Kingdom, there must now be questions about the adequacy of that approach. There can be no doubt that the United Kingdom's focus on the composition of the board and on the crucial importance of NEDs and audit committees was wholeheartedly taken up by all of the Indian committees reviewed in Part 1 of this article. But perhaps the problems are not as acute for India as they would now appear to be for the United Kingdom. Recall that as early as 1998 the CII pointed out that a particular feature of the Indian context was the predominance in the market of PFIs, that is, domestic public sector institutional investors, who were seen to manifest significant shortcomings in their ability to monitor the corporate governance of the companies in which they held shares.20 It now appears, if the UK experience is anything to go by, that the faith the CII placed in the benefits that would accrue with the greater involvement in the Indian market of global private sector institutional investors was misplaced.Nevertheless, a particular feature of the way in which the Indian approach developed was precisely that it did not ultimately depend upon the intervention of institutional investors whether public or private sector--cl.49 of the listing agreement, while ultimately worded in such a way as to suggest that deviation from the requirements is possible, is nevertheless much more prescriptive in tone than the Combined Code and significantly is policed by the regulator, the SEBI.21

The United States

The prescriptive tone of cl.49 derives not from the Combined Code, of course, but rather from the other (and perhaps principal) source of inspiration for corporate governance developments in India during the last decade, namely the Sarbanes-Oxley Act 2002. Turning next, then, to a consideration of how US corporate governance arrangements stand up in the context of the financial crisis, it may equally be asked what the institutional investors were doing in that jurisdiction if not questioning the risky strategies of the banks and other financial institutions, but more importantly how those companies could have got into such a position given the very strict and demanding requirements of the Sarbanes-Oxley Act. The expectation of the legislators in passing that law was, after all, that imposing prescriptive requirements, in particular on the senior officers of a company and on its auditors, and enhancing regulatory oversight by the SEC and the new PCAOB, would make it more difficult for companies to hide problems or to deceive markets.22 So draconian, indeed, were these rules perceived to be that significant doubts were expressed about them from the outset. Beyond those who perceived overtly political reasons for the law23 and those who believed that the market itself would produce a better response to the crisis provoked by the Enron, WorldCom and other cases,24 more moderate voices accepted ***I.C.C.L.R. 86** the need for regulation but were concerned about the implementation, and suggesting that "regulatory intensity" had gone too far, producing undue compliance costs and liability risks.25 Whatever the truth of any of these critiques, there was certainly some compelling evidence to suggest that the intensity of regulation on the US exchanges under Sarbanes-Oxley produced both de-listing and diversion from IPOs as a means of raising capital in favour of the private capital markets.26 This could, of course, be read positively in that if companies avoid markets because they are unable to bear compliance costs or are worried about being exposed to liabilities for breaches of regulation, then those are precisely the sort of companies that the market does not want in

any case. Thus, by clearing out those companies, investors may rest easy that those remaining on or choosing to enter the regulated markets are those in whom they may invest with the greatest confidence. Inconveniently for that reading, however, is the fact that the highest profile casualties of the financial crisis in the United States were all companies listed on the NYSE and thus subject to the supposedly toughest regulation.27

An intriguing point has accordingly been reached in this consideration of the adequacy of Indian corporate governance in the aftermath of the Satyam crisis. Having congratulated itself that it has drawn inspiration from the most advanced models of corporate governance in the world, India might have been minded to take the view that Satyam was no more than a symptom of the need to tighten implementation of existing rules or perhaps at worst of the need for some of the rules proposed in the Companies Bill to be passed into law. Considering the problems that have been manifest in the United Kingdom and the United States, however, it looks more likely that reliance on the fact of an arrangement's provenance in one of those jurisdictions as a marker of its worth will prove to be misplaced.

It is accordingly necessary to go on to consider whether such account as was taken of the particularities of the Indian context by the various committees considering corporate governance during the last decade may be sufficient to render these concerns unnecessary. In other words, if in place of a straight transplantation of concepts from other jurisdictions the committees have rather engaged in a more sophisticated adaptation of these ideas to the Indian context, then it may be that India is actually in a stronger position with regard to corporate governance--albeit perhaps only after the Companies Bill 2009 becomes law--than the jurisdictions from which it has drawn inspiration.

The nature of the Indian transplantation of UK and US corporate governance concepts

Conceptual background

Before embarking on a consideration of the extent to which the transplantation of corporate governance concepts from the United Kingdom and the United States has taken adequate account of the particularities of the Indian context, it is necessary briefly to gain an impression of the controversy that can appear to rage within the field of comparative law with regard to the very idea of legal transplants.

The fact that the various committees reviewed in Part 1 of this article all explicitly looked to foreign models for inspiration for the reform of Indian corporate governance would certainly indicate that they hold that transplants are possible. They accordingly agree with the position put forward by Alan Watson in his influential work on this topic.28 Furthermore, they appear to be following a longstanding tradition insofar as Watson concludes that there has been "continual massive borrowing" between jurisdictions.29 The fact that the various committees were at pains to point out the need to take account of the particularities of the Indian context, however, indicates that legal transplantation is by no means a straightforward or mechanical process. Indeed, this is perhaps so much the case that Watson's critics, most notably Pierre Legrand, have doubted that legal transplants are possible at all.30 Although these positions appear irreconcilable, the strong disagreement between them is perhaps explicable on the basis of the very different approaches that they take to comparative law. In this regard, Watson is essentially a pragmatist, whereas Legrand comes at the problem from a more philosophical position. Thus, whereas Watson is clear that legal rules, institutions and structures can be borrowed ***I.C.C.L.R. 87** by one system from another,31 Legrand is adamant that "rules cannot travel".32 In essence it might be suggested that while Watson is quite happy to separate rules from what he calls the "spirit" of a legal system, Legrand believes that rules cannot be separated from their underlying legal "culture".33 For Legrand, accordingly, it is pointless to talk of a legal transplant because the meaning of a rule (or institution or concept or structure) depends on its original underlying culture and that meaning will inevitably be changed in the context of the host legal culture. Watson professes himself to be unsurprised by this suggestion,

insofar as he claims never to have been closed to the idea that there might be only partial acceptance of a transplant and that the reasons for this would be a key question for investigation by comparative lawyers.34

Despite the vehemence of their disagreement, then, it is probably the case that Watson and Legrand are often talking past each other and agree on more than they admit. Both are apparently clear that the idea of a pure transplant is impossible and that it will always be a matter of considering the impact of the host legal system (whether one wants to use the term "spirit" or "culture") on the meaning of the transplanted concept. There is a sense, then, in which the very term "transplant" may well need to be called into question insofar as it does appear to indicate a more mechanical process than even Watson intends, a point made, for example, by Gunther Teubner.35 Further, even if Watson claims to be open to the idea of the partial acceptance of a legal transplant, this does appear to be a rather awkward modification of a metaphor that seems more naturally to allow only the polar possibilities of acceptance or rejection. By contrast, Teubner's own proposal--legal *irritant* --undoubtedly offers an infinite range of possible outcomes. While Teubner's own use of this concept depends on his very sophisticated and complex theoretical view of society as being composed of a series of autopoietically closed systems of communication, of which law is but one,36 the utility of the concept of a legal irritant does not depend for present purposes on a wholesale acceptance of that theoretical position. Rather, it is possible to concentrate on certain key insights of Teubner's approach that can enlighten the present consideration of the extent to which the reform of Indian corporate governance in recent years has adequately accommodated the specific context into which concepts borrowed from elsewhere are to be inserted.

In this regard, the first point to note is the full implication of Teubner's insistence that any idea of a transplant must be abandoned. The Indian legal system is a distinctive communicative system compared to that either of the United Kingdom or the United States. In implementing reforms that are derived from those systems it is, therefore, not useful to think in terms of information simply being transferred from one jurisdiction to another. Rather, it is necessary to think of the information about those reforms being constructed internally within the Indian legal system.37 Accordingly, whatever may be understood in the United Kingdom by the notion of independence or in the United States by the notion of certification, for example, it is inevitable that these will be understood differently in the context of the Indian legal system. As Rajagopalan and Zhang put it:

"Fundamental differences in ownership structures, business practices, and enforcement standards imply major gaps between formal adoption of progressive and sophisticated governance codes and the actual implementation of these codes."38

The second point to note, accordingly, given the inevitability of this internal construction of the information about reform within the host system, is that any idea that the effect of the reform will be predictable in any strong sense will have to be abandoned. These two points taken together could suggest a very pessimistic reading of any attempt at legal reform inspired by ideas or concepts from another jurisdiction, but it might be more accurate to suggest that Teubner's ideas on legal irritants prompt a more realistic appreciation of what is involved in such a process and encourage a more modest and watchful approach to the ongoing effects. Apart from anything else it does not leave reformers confused in the face of apparent failure ***I.C.C.L.R. 88** or dangerously complacent in the face of apparent success. Rather it points them in the direction in which they should most usefully search for explanations while never naively suggesting that predictability will be possible in the way that linear-causal models of the relationship between law and society might.39

The nature of the Indian context

With this more nuanced understanding of the process of "transplantation" in mind, it is time to consider the particularities of the Indian context, which have so far not been articulated to any great extent, even by the various committees which have considered corporate governance reforms over the past decade. What is it about the Indian context

that would need to be taken into account in order to understand the way in which proposed reforms might be reconstructed in a distinctive way and more specifically in a way that might compromise their intended positive impact? In this regard, Malla Praveen Bhasa offers a useful account of the Indian context, specifically in relation to corporate governance. As part of his effort to identify the various models that characterise corporate governance globally, he suggests that there is a particular model that is evident in emerging economies and he refers to India as a specific example of this type.40 For Bhasa, the particular features that characterise such a model are:

"… vibrant capital markets; successful transition from state held speciality sectors to widely-held firms; existence of relationship-based models as well [as] market-centric governance mechanisms; existence of an emerging managerial labor class; formal and functional legal systems; existence of both family-held firms as well as widely-dispersed firms".41

Insofar as this is a true reflection of the Indian situation, then it is certainly true that while there are features which India shares with both the United Kingdom and the United States, there are also features that are distinct. In what follows, the features identified by Bhasa are considered in turn in order that a clearer picture may be gained of the particularity of the Indian context so that in due course conclusions may be drawn about the adequacy of corporate governance arrangements either in place or in contemplation and if necessary suggestions made about fruitful directions for change.

Formal and functional legal system

On one view, India is in a much stronger position than many other emerging economies with regard to its legal system and company law. It inherited the common law system from the British colonial power, was already influenced by British company law prior to independence and relatively soon after passed the Companies Act 1956 which was modelled to a great extent on the UK Companies Act 1948.42 This means that India's corporate sector enjoys, in principle, legal arrangements that are widely regarded as among the most favourable in the world: the United Kingdom's approach to company law is characterised by a desire to provide "a highly flexible form of vehicle for carrying on business",43 while the common law system is perceived to offer an advantage over the civilian alternative insofar as it appears to impose less rigidity and allow greater adaptability to changing circumstances.44 The practice, however, has been very different. The flexibility of the corporate form has been utilised even in listed companies to the advantage of controlling families at the expense of minority shareholders,45 the period of socialism in particular introduced many rigid prohibitions which reduced the scope for flexibility46 (which restrictions did not necessarily disappear alongside the post-1991 economic reforms47), while the legal system is a byword for corruption and delay meaning that there ***I.C.C.L.R. 89*** is "limited faith in the formal, legal system of governance".48 This state of affairs has led one commentator to suggest that while scoring highly on paper against competitors when it comes to corporate governance, India proves to be an exception to the "adaptability thesis" that understands common law systems as having a comparative advantage over civilian systems in relation to legal innovation:

"… [T]he regulatory adaptability that has been shown in relation to stock markets has emphatically not been a function of judicial law-making … Rather the lesson from Indian stock markets is that rapid regulatory innovation has been successfully achieved by delegation to technocratic regulatory agencies."49

Nevertheless, the gap between principle and practice still needs to be borne in mind: even after the revision of cl.49 following the Murthy Report,50 there is evidence that the level of compliance is poor.51 In relation to financial reporting standards, for example, the "SEBI does not proactively monitor compliance … which is unlike many other international securities markets regulators".52 As Rajagopalan and Zhang put it: "the lax governance environment can be attributed not to the absence of formal governance rules, but to the relatively weak or absent enforcement mechanisms",53 while Khanna, Kogan and Palepu

observe, based on Indian data, that there is evidence of "adoption of some common corporate governance standards but that there is little evidence that these standards have been implemented".54 The ultimate explanation for this state of affairs lies surely in the shortcomings of the court system, leading back once again to that same problem. In short, far from a formal and functional legal system, the Indian context properly understood is characterised by very poor functionality indeed. The Word Bank report on corporate governance in India noted that "prolonged delays are the norm in court proceedings", continuing that "it is not unusual for the first hearing to take six years and the final decision up to 20 years".55 It can accordingly already be suggested that the operability of corporate governance reforms inspired especially by the Sarbanes-Oxley Act needs to be assessed realistically in the light of that understanding. It is also necessary to bear in mind the extent to which, despite the successes of the regulatory agencies, the current overall position in respect of financial regulation is the result of "constant interest-conflicts in the past" rather than of any holistic review.56

Successful transition from state-held speciality sectors to widely held firms

After independence, the Government was declared to have a monopoly in certain strategic areas of the economy, such as defence industries and railways. This nationalisation movement continued in the mid-1950s with more industries being identified as operable only within the public sector. To some extent, India was doing no more in this respect than adopting an approach familiar in many countries, the United Kingdom included, in the post-war era--albeit that the scope was wider and its declared motivations were different. In essence, the state perceived itself to be making up for the absence of the full range of institutions required for the operation of markets, whether for products, labour or capital,57 and its nationalisation efforts ultimately went further than was the case in many others jurisdictions. Thus government suspicion of the private sector, especially with respect to financial transactions, culminated in the nationalisation of banking in 1969.58 Liberalisation commenced in the 1980s and was characterised at that time less by privatisation of the vast state monopolies than by ***I.C.C.L.R. 90** the encouragement of foreign investment in the private sector. A second and more important effort at liberalisation, however, commenced in 1991, less as a result of any ideological commitment than of economic necessity in the context of significant deficits, loss-making state companies and the need for World Bank and IMF assistance.59 It has even been suggested that communist China was much more successful in moving from socialist to market polices than democratic India, with the former leading the latter in reforms by at least a decade.60 While there is, therefore, evidence that where liberalisation has occurred, greater efficiency is achieved, with privately owned firms performing better than state-owned and mixed-ownership firms,61 the assessment that there has been anything approaching a full-blooded transition from a state-dominated economy to a market that is conducive to the emergence of widely held firms must be open to question, as will become even more apparent in the next subsection. As a consequence, corporate governance reforms, for example, that rely upon market monitoring will need to be understood in this context.

Existence of both family-held firms as well as widely dispersed firms

While the decades after independence were dominated by the move to nationalise large areas of the economy, nevertheless outside the restricted industries the private sector was able to thrive. The dominant form of company here, however, was the closely held or family-owned corporation. This form even persisted in the context of the emergence of sizeable conglomerates, since a pyramid structure was employed such that even though individual elements might be widely held, nevertheless control rested firmly with the closely held company at the apex.62 A variety of reasons may be suggested for this phenomenon. For example, the dominance of family-owned firms in the small and

medium-sized sector has been explained as a rational response to the weakness of protections for property rights and this approach accordingly continues as a company grows, even as it in due course lists on a public exchange.63 Similarly, the need to compensate for weak property rights has also been proposed as a reason for the prevalence of corporate groups in emerging economies such as India.64 But what might have been a virtue in the context of a small business (or even a corporate group) concerned about property rights risks becoming a vice in the context of a publicly listed company.65 On the other hand, it has been suggested that the emergence of closely held groups may be understood as the private sector analogue of state intervention in response to the absence of the full range of institutions required for the functioning of efficient and effective markets.66 This raises a variation on the traditional agency problem that corporate governance seeks to solve: instead of the main concern being expropriation of shareholders' investments by self-interested directors, the focus shifts to the expropriation of minority shareholders' investments by the majority.67 The presence of significant stable blocks of closely held shares combined with portions of widely dispersed holdings leads to "information asymmetries and agency costs" that are "substantial".68 The key task for corporate governance thus becomes one of "disciplining the dominant shareholder".69 It is also noteworthy that empirical evidence points to a marked ***I.C.C.L.R. 91** preference for debt as opposed to equity in the capital structure of group-affiliated companies as opposed to non-affiliated companies.70 This apparent *preference* could, however, equally be read as an indication of a greater *availability* of debt as compared to equity for group-affiliated companies. It has been suggested in this respect that where monitoring and enforcement are problematical and where the protection of minority investors is inadequate, a society will manifest more debt than equity finance as the deficits in monitoring and enforcement are compensated for by the long-term relationship between the bank and the company.71 This observation of the situation in India could also help to explain the problems with the adaptability thesis mentioned above: there is some suggestion that although the common law can assist in the development of both market and bank financing, nevertheless where financial markets are not highly developed common law serves to enhance the development of bank financing.72 This economic evidence could, accordingly, point to deficits in basic corporate governance arrangements. Beyond this, and a point not emphasised by Bhasa, is the fact that a significant proportion of the economy remains in the hands of around 240 government companies (many not profitable)73 including some 40 listed entities which together account for around 20 per cent of the market capitalisation of the Bombay Stock Exchange.74 The picture is thus more complex than appears to be the case at first sight, not least when one recalls the Irani Committee's concerns about the Government's tendency to excuse governance failings on the part of the directors of such companies75 and also the Government's continued reservation of the right to disapply company law provisions in relation to government companies in the context of the Companies Bill 2009.76 Accordingly, economic data that point to India as an exception to the emerging market rule--insofar as equity finance has expanded as debt finance has stagnated77 --need to be understood in this much more complex context and not read simplistically as an indication of the appearance of a fully functioning market characterised by widely dispersed holdings. It is not insignificant that there is evidence to suggest that the expansion in equity financing in recent years has been due in large part to retained earnings as opposed to new investment.78 Similarly, the operability of reforms inspired by jurisdictions where listed closely held firms and government companies are practically unheard of will need to be understood in that same context.

Vibrant capital markets

It is important to realise, then, that the companies listed on the principal Indian stock exchanges are more diverse in character than those that would be encountered on the LSE or NYSE. As Lavelle puts it, "multinational corporations … operate alongside traditional Indian business houses and partially privatised state-controlled firms".79 It is also important to realise that the stock exchanges, almost paradoxically, were actually an obstacle to the second wave of liberalisation commencing in 1991, owing, inter alia, to the

effective dominance among traders of one ethnic grouping, complex and outdated procedures which were open to manipulation both by brokers and issuers, and extraordinarily restricted business hours utterly at odds with international practice. It might even be suggested that despite the fact that the thinking behind the SEBI was that it should be a modern independent agency ensuring the proper functioning of the market,80 it was less the appearance of this regulator than of effective competition for the Bombay Stock Exchange in the form of the National Stock Exchange that finally produced progress towards something approaching an effective functioning system81 --an observation ***I.C.C.L.R. 92** that impacts McGee's enthusiasm for the regulator over the courts reported above.82 Empirical research also provides evidence that the internal governance of the NSE is superior to that of the BSE, providing a further driver for overall improvements.83 There is also empirical evidence to support the proposition that these improvements have actually fed through to enhanced oversight of listed companies and thus enhanced visibility of company information making monitoring by investors more straightforward.84 It might accordingly be concluded that whereas the Indian stock market may look very different from its UK and US counterparts that have inspired recent corporate governance reforms, there is nevertheless cogency to the argument that the advent of competition has produced a vibrancy that has in turn produced positive results. Empirical evidence suggests that this process must, however, be understood as very far from complete. Nevertheless, this observation perhaps indicates that more could be achieved if the market was suitably empowered--something that offers hope to those UK-inspired reforms that rely on market monitoring.

Existence of relationship-based models as well as market-centric governance mechanisms

The appearance of market-centric mechanisms in India has been reviewed in the preceding subsection and indeed throughout Part 1 of this article. The relationship-based models, however, require closer examination. There are two dimensions to be considered here. The first is the role of the public financial institutions as shareholders, while the second is the existence of close relationships between business groups and the government. The role of the PFIs has already been discussed, with the CII expressing concern that these bodies did not exercise the sort of oversight of governance that might be expected of private sector institutional investors.85 While there is evidence that their engagement with companies on governance issues improves with the level of debt that they hold,86 there is equally evidence that their performance in relation to governance is still problematical where they hold debt rather than equity.87 It is also worth noting in this regard that the World Bank review of accounting and audit in India revealed that a "significant proportion of sampled banks and financial institutions failed to fully apply the requirements of the Indian Accounting Standard on 'related party transactions"'.88 While it has since been seen that these latter investors frequently actually prioritise performance over governance,89 it would appear from more recent evidence that PFIs are essentially behaving in the same way. Mohanty, for example, while confirming that there is no evident effect of PFIs on companies' corporate governance records, nevertheless shows that PFIs have focused their investment attention on those companies with good financial performance.90 The exception to this rule appears to be in situations where PFIs hold a stake larger than 25 per cent where greater engagement in governance is apparent.91 In short, the evidence suggests that institutional investors of whichever variety are focused more on short-term gain than long-term growth and thus have few incentives to concern themselves with governance issues.92 While it is easy to be critical of institutional investors in the Indian context, it is necessary to consider the opportunities that are available to them as well as the restrictions that they must operate under. The picture is mixed to say the least. On the positive side, there has been a very significant development of the private sector in relation to mutual funds with the market share of the previous state monopoly diminishing to a mere ten per cent. Equally, those mutual funds are relatively unrestricted in their operations compared to other parts of the Indian financial sector.93 Furthermore, there is evidence ***I.C.C.L.R. 93** that the liberalisation of financial markets and the advent of

foreign institutional investment has had positive effects in reducing agency costs as a result of enhanced monitoring and increased shareholder activism.94 Empirical research confirms greater engagement by foreign institutional investors compared to PFIs and concludes that the formers' "buying preferences have led to imposition of a penalty on stock valuations of those firms that have group cross holding, inadequate disclosure, or are closely held".95 In other words, some scope exists for institutions in this field to play a more active role in corporate governance. On the other hand, while mutual funds may not be as tightly controlled as Indian banks,96 it is nevertheless the case that they are relatively strictly regulated compared to their counterparts in developed markets and are subject to "resource pre-emption" which forces them to hold government bonds well in excess of normal prudential requirements.97 Nor do they appear to have been much more effective than PFIs when it comes to monitoring the companies in which they invest.98 Furthermore, the remaining public sector bodies have experienced difficulty themselves in complying with financial reporting requirements but have rarely had any sanction imposed upon them.99 All of this limits the development of a free market characterised by economically rational behaviour on the part of institutional investors, including decisions based on good governance. On the positive side once again is the relative openness of the Indian economy to foreign institutional investors as well as evidence that the scale of such investment has increased significantly in the past decade together with indications that this investment flows to well-governed companies.100 There is also evidence that the market in India has been an effective mechanism in penalising companies which have poor records in relation to environmental regulation, which offers support for the idea that scope exists for institutional investors to bolster the efforts of regulators in relation to corporate governance.101 This apparently very positive picture needs to be understood in detail, however. A closer look reveals that over that period the opportunities for foreign institutional investment have actually decreased as the promoters of closely held listed companies have increased their stakes. Foreign institutional investment has thus increased in scale, but is concentrated on companies that meet criteria of size, liquidity and corporate governance.102 In other words, the opportunity for engagement by domestic or foreign institutional investors in corporate governance certainly exists, but there are features of the Indian context, both in terms of regulation and the way in which companies are held, that appear to inhibit the desired behaviour.103 Turning now to the relationship between business groups and government, it is useful to trace this historically. The nationalisation drive after independence may certainly be read as an effort by the state to make up for the absence of the full range of institutions required for properly functioning markets. The other side of this coin is, however, that powerful business groups were able to exploit the absence of these institutions for their own benefit. Nevertheless, even in the succeeding period, with the private sector significantly restricted with regard to the sectors of the economy in which it could operate, there is evidence that different groups at different times had preferential access to licences and permits.104 Once again, however, it is necessary to take as objective a view of this phenomenon as possible. While this could be seen negatively as pure rent-seeking behaviour, it might just as easily be viewed positively as the inevitable effort of the business sector to accommodate itself to a governmental system that was far from perfect.105 Either way, however, the existence of relationship-based aspects of governance does not necessarily reflect a healthy governance situation and indicates the extent of the challenge facing those who would endeavour to effect ***I.C.C.L.R. 94** reform. This impacts, for example, reforms that rely on market monitoring, thus tempering the conclusion reached at the end of the preceding subsection.

Existence of an emerging managerial labour class

As Indian companies began to compete globally, the need for management by professionals, as opposed to family members irrespective of their training or abilities, became clear. This produced both a growing indigenous professional class as well as an effort on the part of Indian companies to recruit talent internationally. This last point appears to have had an impact on corporate governance in an indirect and perhaps unexpected way: it has been suggested that some Indian companies, notably those in the

software sector, listed on US stock exchanges less as a means of raising capital (which they had little need of, given the availability of capital domestically) than of allowing them to compete for international talent in a labourmarket where stock options denominated in dollars are (or at any rate were) an essential feature of an attractive remuneration package.106 Exposure to the governance standards of US exchanges engendered in this way was thus a side-effect of the need for talent rather than for capital. Nevertheless, this fact, together with the undoubted growth in the indigenous managerial class trained in internationally recognised business and law schools at home and abroad, bodes well for corporate governance reform inasmuch as there is a sizeable younger generation for whom the concepts have been familiar from the outset. This is a significant factor to be considered in assessing the way in which reform inspired by UK and US concepts will be understood in the Indian context.107

Concluding remarks on the evaluation of corporate governance reforms in India

At the end of this evaluation of corporate governance reforms in India, there would appear to be a rather mixed picture. On the one hand, the various committees whose work was reviewed in Part 1 of this article appear to have accommodated the particularities of the Indian context by drawing inspiration from both the United Kingdom and the United States rather than relying only on one. As a consequence, while there appear to be both opportunities and obstacles for market monitoring in India, the fact that there is greater scope for regulatory intervention on the part of the SEBI with regard to the way in which cl.49 of the listing agreement is implemented would appear to be a rational response to the obstacles. On the other hand, the fact that the superficial similarities between the Indian public exchanges and those in the United Kingdom and the United States disappear under a closer examination mean that extreme caution is appropriate in any exercise to reform Indian corporate governance on the basis of concepts borrowed from elsewhere--a fortiori when the problems besetting the legal system as a whole are considered. Teubner's suggestion that the metaphor of the legal irritant is more accurate than that of the legal transplant looks entirely appropriate in this context.108 And this unstable situation is further undermined by the fact that, as was seen above, the very jurisdictions that were the sources of inspiration for the development of Indian corporate governance are currently in the throes of their own crises of confidence as to the adequacy of their own arrangements. The observation by Berglöf and von Thadden that any too easy read-across of corporate governance ideas from developed to developing and transition economies must be avoided thus takes on even greater importance.109 There is accordingly a clear need for the Indian Government to tread carefully as the Companies Bill 2009 progresses through Parliament. The degree of uncertainty evident in the domain of corporate governance would provide a ready-made excuse for yet another attempt at the reform of company law in India to be stalled pending another review. But as the third and final part of this article will argue, that would be to risk losing the opportunity to send a clear and unequivocal message to the domestic and international investors whose support will be required for the growth that India envisages.110 ***I.C.C.L.R. 95*** Accordingly, proposals are made for priorities and amendments to the Companies Bill that seek to take account of the particularities of the Indian context that have been discussed above while not forgetting the lesson that any borrowing between systems should best be understood as an irritant with unpredictable effects that will require close monitoring rather than as amechanistic transplant that can simply be set running without further ado.

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1. The IMF estimates that "total write-downs could reach $4 trillion over the next two years". See IMF, *Global Financial Outlook April 2009: Crisis and Recovery* (Washington: International Monetary Fund, 2009), pxii.

2. The banks principally affected by the crisis in the UK have been Northern Rock, RBS and HBOS.

3. The House of Commons Treasury Select Committee is unequivocal in its assessment, stating that "By any measure the FSA [Financial Services Authority] has failed dreadfully in its supervision of the banking sector". See *Banking Crisis: regulation and supervision.Fourteenth Report of Session 2008-09.* The Stationery Office, 2009 HC 767, p.3. For its part, the FSA accepts problems with regulation and supervision, for example, the extent to which regulators had accepted banks' sophisticated mathematical techniques for risk management. See Lord Turner, *The Turner Review: a regulatory response to the global banking crisis* (London: Financial Services Authority, 2009), para.1.1. At the EU level the High-Level Group on Financial Supervision "believes that the world's monetary authorities and its regulatory and supervisory financial authorities can and must do much better in the future to reduce the chances of events like these happening again". See *The Report of the High-Level Group on Financial Supervision in the EU,* chaired by Jacques de Larosière, Brussels, February 25, 2009, p.6.

4. See Paul Davies and Jonathan Rickford, "An Introduction to the New UK Companies Act" [2008] E.C.F.R. 48, 51 fn.9.

5. Turner Review, 2009, p.92.

6. Turner Review, 2009, p.93.

7. FSA, Listing Rules (LR) 9.8.6(5) and (6).

8. Combined Code, Preamble para.3.

9. LR 9.8.6(5) requires that a listed company's annual financial report includes "a statement of how the listed company has applied the principles set out in Section 1 of the Combined Code". LR 9.8.6(6) requires that a listed company's annual financial report includes a statement as to whether or not it has complied with the provisions of s.1 of the Combined Code and if not which it did not comply with and the reasons.

10. Combined Code s.2.

11. Turner Review, 2009, p.93.

12. DavidWalker, *A Review of Corporate Governance in UK Banks and other Financial Industry Entities* (London: HM Treasury, 2009), para.5.9.

13. Iain MacNeil and Xiao Li, "'Comply or Explain': market discipline and non-compliance with the Combined Code" (2006) 14 *Corporate Governance* 486.

14. Combined Code para.5. See also, Sridhar Arcot and Valentina Giulia Bruno, "In Letter but not in Spirit: An Analysis of Corporate Governance in the UK", May 2006, available at SSRN: *http://ssrn.com/abstract=819784* [Accessed December 8, 2009]; "One Size Does Not Fit All, After All: Evidence from Corporate Governance", January 15, 2007, 1st Annual Conference on Empirical Legal Studies, forthcoming, available at SSRN: *http://ssrn.com/abstract=887947* [Accessed December 8, 2009].

15. MacNeil and Li, "'Comply or Explain"' (2006) 14 *Corporate Governance* 486, 489.

16. See, for example, A. Shleifer and R. Vishny, "Large shareholders and corporate control" (1986) 96 *Journal of Political Economy* 461; R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny, "Legal determinants of external finance" (1997) 57 *Journal of Finance* 1147.

17. MacNeil and Li, "'Comply or Explain"' (2006) 14 *Corporate Governance* 486, 492.

18. MacNeil and Li, "'Comply or Explain"' (2006) 14 *Corporate Governance* 486, 492.

19. As just one example, the Northern Rock bank was a particularly strong performer, but only because of an extremely risky business strategy that was heavily dependent on the availability of credit and which investors were apparently prepared to accept instead of questioning as the Combined Code would have expected. See Roman Tomasic, "Corporate rescue, governance and risk-taking in Northern Rock: Part 1" (2008) 29 *Company Lawyer* 297.

20. See J. Paterson, "Corporate Governance in India in the Context of the Companies Bill 2009 (Part 1: Evolution)" [2010] I.C.C.L R. 41, fnn.18-20 and associated text.

21. See Paterson, "Corporate Governance in India (Part 1)" [2010] I.C.C.L R. 41, for a discussion of the revised cl.49 of the listing agreement.

22. See Paterson, "Corporate Governance in India (Part 1)" [2010] I.C.C.L R. 41, fn.6 and associated text.

23. See, for example, Roberto Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate

Governance” 92005) 114 *Yale Law Journal* 1521.

24. See, for example, Larry E. Ribstein, “Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002” (2002) 28(1) *Journal of Corporation Law* 1.

25. Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation,* November 30, 2006, p.4.

26. Committee on Capital Markets Regulation, *Interim Report,* 2006. See also Committee on Capital Markets Regulation, *The Competitive Position of the U.S. Public Equity Market,* December 4, 2007.

27. For example, Bear Sterns, Lehman Brothers, AIG.

28. Alan Watson, *Legal Transplants: An Approach to Comparative Law* (Edinburgh: Scottish Academic Press, 1974).

29. Watson, *Legal Transplants,* 1974, p.107.

30. Pierre Legrand, “The Impossibility of ‘Legal Transplants”’ (1997) 4 *Maastricht Journal of European and Comparative Law* 111; see also “What ‘Legal Transplants'?” in David Nelken and Johannes Feest (eds), *Adapting Legal Cultures* (Oxford and Portland, Oregon: Hart, 2001), pp.54-70.

31. Alan Watson, “Legal transplants and European private law”, *Electronic Journal of Comparative Law,* December 2000, 4(4), section I, at *http://www.ejcl.org/44/art44-2.html* [Accessed January 3, 2010.]

32. Legrand, “The Impossibility of ‘Legal Transplants”’ (1997) 4 *Maastricht Journal of European and Comparative Law* 111, 114.

33. Legrand, “The Impossibility of ‘Legal Transplants”’ (1997) 4 *Maastricht Journal of European and Comparative Law* 111, 115-116.

34. Watson, “Legal transplants and European private law”, *Electronic Journal of Comparative Law,* December 2000, 4(4), section VII.

35. Gunther Teubner, “Legal irritants: good faith in British Law or how unifying law ends up in new divergences” (1998) 61(1) *Modern Law Review* 11, 11.

36. See especially, Gunther Teubner, *Law as an Autopoietic System* (Oxford: Blackwell, 1993).

37. It is possible to complexify this account further by considering the impact of the fact that the same reform efforts will also be differentially internally constructed by the economic and political systems in India, but this is beyond the scope of the present article. See John Paterson and Gunther Teubner, “Changing Maps: Empirical Legal Autopoiesis” (1998) 7(4) *Social and Legal Studies* 451; and Niklas Luhmann, “Limits of Steering” (1997) 14(1) *Theory, Culture and Society* 41.

38. Nandini Rajagopalan and Yan Zhang, “Corporate Governance Reforms in China and India: Challenges and Opportunities” (2008) 51 *Business Horizons* 55, 56.

39. For a discussion, see John Paterson, “Reflecting on Reflexive Law” in Michael King and Chris Thornhill (eds), *Luhmann on Politics and Law: Critical Appraisals and Applications* (Oxford: Hart, 2006), pp.13-35.

40. Malla Praveen Bhasa, “Understanding the corporate governance quadrilateral” (2004) 4(4) *Corporate Governance* 7, 15. For readily accessible general introductions to the Indian political and economic context, see Grahame Allen and Janna Jessee, “An economic introduction to India”, *House of Commons Library Research Paper* 07/40, May 2, 2007; and Tom Harrison, Sam Jones, Jon Lunn, Ben Smith, Claire Taylor and Tim Youngs, “A political introduction to India”, *House of Commons Library Research Paper* 07/41, May 2, 2007.

41. Bhasa, “Understanding the corporate governance quadrilateral” (2004) 4(4) *Corporate Governance* 7, 14.

42. See S. Verma and S.J. Gray, “The development of company law in India: the case of the Companies Act 1956”, *Critical Perspectives on Accounting,* 20(1), 110-135.

43. Paul L. Davies, *Principles of Modern Company Law,* 8th edn (London: Sweet and Maxwell, 2008), p.1.

44. See Konrad Zweigert and Hein Kötz, *Introduction to Comparative Law,* 3rd edn (Oxford: Clarendon Press, 1998), pp.256 et seq. For an economic reading of the presumed advantages of common law over civil law systems in the emergence of functioning equity markets, see Ozgur E. Ergungor, “Market- vs. bank-based financial systems: do rights and regulations really matter?” (2004) 28(12) *Journal of Banking and Finance* 2869. For an optimistic view of the Indian legal system see Anshu Saran and Chiquan Guo, “Competing in

the global marketplace: The case of India and China" (2005) 48 *Business Horizons* 135, 141.

45. On which point see further below.

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47. See Naushad Forbes, Doing Business in India: What has Liberalization Changed?" in Anne O. Krueger (ed.), *Economic Policy Reforms and the Indian Economy,* 2nd edn (Chicago: University of Chicago Press, 2002), pp.129-168.

48. Rajesh Chakrabarti, William L. Megginson and Pradeep K. Yadav, "Corporate Governance in India", *Journal of Applied Corporate Finance* (forthcoming--references are to pre-publication typescript), p.22.

49. Robert W. McGee, "Corporate Governance in Asia: Eight Case Studies", Florida International University, College of Business Administration, School of Accounting, Working Paper, January 2008.

50. See Paterson, "Corporate Governance in India in the Context of the Companies Bill 2009 (Part 1: Evolution)" [2010] I.C.C.L R. 41.

51. See World Bank, *Report on the Observance of Standards and Codes, Corporate Governance Country Assessment: India,* April 2004, Document of the World Bank, 35084, Section IV. See also Rajesh Chakrabarti, "Corporate Governance in India: Evolution and Challenges", January 17, 2005, p.19, available at SSRN: *http://ssrn.com/abstract=649857* [Accessed December 8, 2009]. See also Nandini Rajagopalan and Yan Zhang, "Recurring failures in corporate governance: a global disease?" *Business Horizons,* 2009, vol.52, 545-552, 545.

52. World Bank, Financial Management Unit, South Asia Region, *India: Report on the Observance of Standards and Codes--Accounting and Auditing,* Document of the World Bank, Report No.32510-IN, para.46.

53. Rajagopalan and Zhang, "Corporate Governance Reforms in China and India" *Business Horizons,* 2009, p.60.

54. Tarun Khanna, Joe Kogan, and Krishna Palepu, "Globalization and Similarities in Corporate Governance: A Cross-Country Analysis" (2006) 88(1) *Review of Economics and Statistics* 69, 84.

55. World Bank, *India: Report on the Observance of Standards and Codes,* Report No.32510-IN, p.6.

56. A.K. Sharma and Ashutosh Vashishtha, "Dynamics and regulatory system of Indian financial markets: a dialectic view" (2007) 15(3) *Journal of Financial Regulation and Compliance* 275, 286.

57. Tarun Khanna and Krishna G. Palepu, "The Evolution of Concentrated Ownership in India" in Randall K. Morck (ed.), *History of Corporate Governance around the World: Family Business Groups to Professional Managers* (Chicago, Ill.: University of Chicago Press, 2006), p.298. See also Tarun Khanna and Krishna Palepu, "Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups" (2000) 55(2) *Journal of Finance* 867.

58. Kathryn C. Lavelle, *The Politics of Equity Finance in Emerging Markets* (Cary, NC: Oxford University Press, 2004), p.117.

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61. S.K. Majumdar, "Assessing Comparative Efficiency of the State-Owned Mixed and Private Sectors in Indian Industry" (1998) 96 *Public Choice* 1, cited in Diane K. Denis and John J. McConnell "International Corporate Governance" (2003) 38(1) *Journal of Financial and Quantitative Analysis* 1.

62. Lavelle, *The Politics of Equity Finance in Emerging Markets,* 2004, p.118.

63. Chakrabarti, Megginson and Yadav, "Corporate Governance in India", *Journal of Applied Corporate Finance* (forthcoming), p.22.

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78. Shah, Thomas and Gorham, *India's Financial Markets,* 2008, p.38.

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82. See above fn.49 and associated text.

83. See Chandrasekhar Krishnamurti, John M. Sequeira and Fu Fangjian, “Stock exchange governance and market quality” (2003) 27 *Journal of Banking & Finance* 1859. See also James J. Angel, “Discussion of ‘Stock exchange governance and market quality’ by Krishnamurti, Sequeira, and Fangjian” (2003) 27 *Journal of Banking & Finance* 1879 who stresses the importance of government support as an explanation for the success of the NSE.

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92. Rajagopalan and Zhang, "Corporate Governance Reforms in China and India" (2008) 51 *Business Horizons* 55, 60.

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94. See Chinmoy Ghosh, John Harding and B.V. Phani, "Does liberalization reduce agency costs? Evidence from the Indian banking sector" (2008) 32 *Journal of Banking & Finance* 405.

95. Murali Patibandla, "Equity pattern, corporate governance and performance: A study of India's corporate sector" (2006) 59 *Journal of Economic Behavior & Organization* 42. See also Sarkar and Sarkar, "Large Shareholder Activism in Corporate Governance in Emerging Economies", January 1999, IGIDR Working Paper No.153, p.19.

96. Shah, Thomas and Gorham, *India's Financial Markets,* 2008, p.177.

97. Shah, Thomas and Gorham, *India's Financial Markets,* 2008, pp.195-196.

98. See Uma S. Kambhampati, "Financial liberalisation, corporate governance and the efficiency of firms in Indian manufacturing" (2006) 17 *Structural Change and Economic Dynamics* 46.

99. World Bank, *India: Report on the Observance of Standards and Codes,* No.32510-IN, para.49.

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101. See Shreekant Gupta and Bishwanath Goldar, "Do stock markets penalize environment-unfriendly behaviour? Evidence from India" (2005) 52 *Ecological Economics* 81.

102. Shah, Thomas and Gorham, *India's Financial Markets,* 2008, pp.187-188, 214.

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104. See Joan Esteban and Debraj Ray "Inequality, Lobbying, and Resource Allocation" (2006) 96(1) *American Economic Review* 257.

105. Khanna and Palepu, "The Evolution of Concentrated Ownership in India" in *History of Corporate Governance around the* World, 2006, p.297.

106. See Khanna and Palepu, "The Evolution of Concentrated Ownership in India" in *History of Corporate Governance around the* World, 2006, p.315.

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