CORPORATE GOVERNANCE PRACTICES IN ASIA

Dr Anil Kumar
Associate Professor and Coordinator
Centre of Corporate Governance

SHRI RAM COLLEGE OF COMMERCE

PREFACE

This project on *Corporate Governance Practices in Asia* awarded by the National Foundation for Corporate Governance (NFCG) to Shri Ram College of Commerce (SRCC) focuses on issues of corporate governance in Asia. The study is undertaken to seek answers to some basic aspects of corporate governance in Asia:

- What are the commonalities in corporate governance in Asia?
- What are the governance challenges in Asia?
- How the system of corporate governance in Asian countries strives to solve the problems of corporate governance?
- What are the areas which call for improvements?

Asian countries are thought to be plummeted by poor transparency, vague corporate governance structures and poor implementation of the law taking a toll on the rights of minority shareholders. The combining of ownership and control in a few business families which is quite prevalent in most of the Asia averts the typical agency conflict of owner-manager prevalent in the western world especially Anglo-Saxon countries. The agency problem prevalent in the Asian region is the conflict between the majority shareholders who act as mangers also and minority shareholders. A lot of improvements have taken place in the governance structures and practices of the Asian countries in the aftermath of the Asian crisis 1997 and opening up of the economies.

This study extensively covers important Asian countries- China including Hong Kong, Japan, Malaysia, South Korea, Singapore, Middle East countries and SAARC countries including India. The time-period of the study from 2013 to 2014 was the phase when most Asian countries attempted drastic reforms in their governance structures by reviewing existing regulations to bring about the new ones or major amendment. The Indian Companies Act 2013 and Companies Ordinance 2014 of the Hong Kong are such pieces of legislation which should be a water mark for most other Asian countries. The Acts have provisions on independent directors' appointment, duties of directors, audit committee requirements, whistle-blowing mechanism and corporate social responsibility. This study brings to fore most of the recent legislative developments impacting corporate governance in Asia.

This report should be of use for the academicians, practitioners and policy-makers in gaining understanding on the subject and taking forward on agenda of corporate governance reforms in Asia which may possibly be attempted by bringing about changes in the regulatory framework and its effective implementation.

ACKNOWLEDGEMENT

We wish to express our warm and sincere thanks to Mr Ajay S. Shriram, Chairman, Governing Body of SRCC and presently President of the CII for his constant support and encouragement in setting up of the Centre of Corporate Governance in the college. The ideas and motivation provided by Dr P.C. Jain Principal of SRCC have had a remarkable influence on this research work. Mr Soumitra K. Choudhury has always stood for all helps and advise for completion of this task.

During this work, we have long discussions with Professors of Waseda University, Tokyo- Hideaki Miyajima, Hirokazu Hasegawa and Takashi Yoneda; Professor Susela Devi, University of Malaya; and Professor Marc Goergen from Cardiff Business School, UK . We wish to extend our warmest thanks to all of them.

We owe our sincere gratitude to the officials of the NFCG in particular Ms Shalini Budathoki, Executive Director and MrVineet Mishra, Executive Officer who gave us their whole hearted cooperation during the research. Mr Vijay Kapur and MrSutanu Sinha deserve special thanks for extending their cooperation.

This work would not have been completed but for the background work of the team of SRCC students consisting of Akanksha Gupta, Anisha Shrivastva, Ankit Karan Singh, Ashima Gujral, Asmita Sachdeva, Ateeshay Jain, Dhanjay Singh Yadav, Neharika Sobti, Nishtha Khandelwal, Parth Bhavsar and Srishti Jain.

The financial support of National Foundation for Corporate Governance is gratefully acknowledged.

October 31, 2014

Dr Anil Kumar
Associate Professor and Coordinator
Centre of Corporate Governance
Shri Ram College of Commerce
Delhi-110007
E.Mail: anilkumar@srcc.edu

About National Foundation for Corporate Governance (NFCG)

With the goal of promoting better corporate governance practices in India, the Ministry of Corporate Affairs, Government of India, on 1st October 2003 set up National Foundation for Corporate Governance (NFCG) in partnership with Confederation of Indian Industry (CII), Institute of Company Secretaries of India (ICSI) and Institute of Chartered Accountants of India (ICAI).

In the year 2010, stakeholders in NFCG have been expanded with the inclusion of ICAI and the National Stock Exchange.

Vision

Be a Catalyst in Making India the Best in Corporate Governance Practices.

Mission

1. To foster a culture for promoting good governance, voluntary compliance and facilitate effective participation of different stakeholders;
2. To create a framework of best practices, structure, processes and ethics;
3. To make significant difference to Indian Corporate Sector by raising the standard of corporate governance in India towards achieving stability and growth.

Stakeholders

Ministry of Corporate Affairs (MCA): MCA is primarily concerned with administration of the Companies Act, other allied Acts and rules & regulations framed there-under mainly for regulating the functioning of the corporate sector in accordance with law. The Ministry is also responsible for administering the Competition Act, 2002 which will eventually replace the Monopolies and Restrictive Trade Practices 5 Act, 1969 under which the Monopolies and Restrictive Trade Practices Commission (MRTPC) is functioning. Besides, it exercises supervision over the three professional bodies, namely, Institute of Chartered Accountants of India (ICAI), Institute of Company Secretaries of India (ICSI) and The Institute of Cost Accountants of India (ICAI) which are constituted under three separate Acts of the Parliament for proper and orderly growth of the professions concerned. The Ministry also has the responsibility of carrying out the functions of the Central Government relating to administration of Partnership Act, 1932, the Companies (Donations to National Funds) Act, 1951 and Societies Registration Act, 1980.

Confederation of Indian Industry (CII): CII is a non-government, not for profit, industry led and industry-managed organization, playing proactive role in India's development process. CII works to create and sustain an environment conductive to the growth of industry in India, parenting Industry through advisory and consultative processes. A facilitator, CII catalyses change by working closely with government on policy issues, enhancing efficiency, competitiveness and expanding business opportunities for industry through a range of specialized services and global linkages.

Institute of Chartered Accountants of India (ICAI): ICAI is a statutory body established under the Chartered Accountants Act, 1949 for the regulation of the profession of Chartered Accountancy in India. The Institute has achieved recognition as a premier accounting body for the contribution in the fields of education, professional development, maintenance of high accounting, auditing and ethical standards.

Institute of Company Secretaries of India (ICSI): ICSI is a premier national professional body constituted under the Company Secretaries of India Act, 1980 to develop and regulate the profession of Company Secretaries. The Institute is functioning 6 to develop high caliber professionals ensuring good Corporate Governance and effective management, thus contributing to society at large.

The Institute of Cost Accountants of India: The Institute of Cost Accountants of India was established by an Act of Parliament, namely, the Cost and Works Accountant Act, 1959. The institute was formed with the objectives of promoting, regulating and developing the profession of Cost Accountancy and is under the administrative control of Ministry of Corporate Affairs. The Institute is a founder member of International Federation of Accountants (IFAC), Confederation of Asian and Pacific Accountants (CAPA) and South Asian Federation of Accountants (SAFA).

National Stock Exchange of India Limited (NSE):NSE operates a nation-wide, electronic market, offering trading in Capital Market, Derivatives Market and Currency Derivatives segments, including equities based ETF, Gold ETF, and Retail Government Securities etc. It accounts for nearly 74% in Equity market and more than 98% market share in equity derivatives segment. Today NSE network stretches to more than 1,500 locations in the country and supports more than 2, 30,000 terminals. With more than 10 asset classes in offering, NSE has taken many initiatives to strengthen the securities industry and has launched several new products like Mini Nifty, Long Dated Options, Cross Margining, Currency and Interest Rate Derivatives, and Mutual Fund Service System. Responding to the evolving market needs, NSE has also introduced services like DMA, FIX capabilities, co-location and mobile trading facilities for various categories of investors. NSE is committed to operate a market ecosystem which is transparent and at the same time offers high levels of safety, integrity and corporate governance. NSE would 7 continue to provide newer products and services to cater to the demands of the market participants and provide an efficient trading platform for the investors

About Shri Ram College of Commerce (SRCC)

The Shri Ram College of Commerce (SRCC), founded in 1926 is a premier institution of India in the fields of business and economics studies. A constituent college of the University of Delhi, SRCC is an accredited institution of the National Foundation for Corporate Governance (NFCG). It offers courses at the undergraduate and post-graduate levels in commerce, business and economics. The college has a rich inheritance and repertoire of academic excellence which it directs towards development and dissemination in tune with contemporary requirements. The faculty and academic infrastructure are rated to be one of the best in the fields. Alumni of the college are spread over diverse fields of business, industry, governance, banking, judiciary and academics and occupy positions of eminence in India and abroad. MrArunJaitly, Hon'ble Union Minister for Finance and Corporate Affairs, Government of India is one of the most distinguished alumni of the college.

SRCC has built collaborative partnerships with reputed Business Schools and Universities abroad: IESEG Business School, Paris & Lille, Sciences-Po, Paris; Utrecht Business School, Netherlands; Hong Kong Business School; University of Warsaw, Poland; Assumption University, Bangkok; University of Wisconsin, Eau Claire, US; Pennsylvania State University, US and South Pacific University; Cardiff Business School (UK); University of Namibia; and Saginaw Valley State University, US.

The college has been accorded the status of National Centre of Corporate Governance by the National Foundation for Corporate Governance, New Delhi. SRCC is the only College of Delhi University which has been conferred with the status. The Centre conducts research, workshops and conferences to build and disseminate knowledge of corporate governance. The College organised the International Conference on "Corporate Governance in Asia and Business Sustainability on October 7-9, 2013 at Bangkok, Thailand. The conference was inaugurated by the 27th Prime Minister of Thailand. In September 2014, the college organised three international conferences at Cardiff (UK), Michigan (USA) and Namibia on the broad theme of corporate governance and business sustainability.

CORPORATE GOVERNANCE PRACTICES IN ASIA

Contents

EXECUTIVE SUMMARY 1-20

1 INTRODUCTION 21

1.1 Meaning and Significance of Corporate Governance 21

1.2 Model of Corporate Governance in Asia 22

1.3 Ownership and Control Structures 26

1.4 Issues of Corporate Governance in Asia 26

2 CORPORATE GOVERNANCE IN CHINA AND HONG KONG 28

2.1 People's Republic of China 28

2.1.1 Country Analysis 28

2.1.2 Corporate Governance in China 28

2.1.3 Code of Corporate Governance 30

2.1.4 Distinctive Features of Chinese Corporate Governance 33

2.1.5 Corporate Governance Practices of Listed Companies in China 36

2.2 Hong Kong 44

2.2.1 Country Analysis 44

2.2.2 Corporate Governance in Hong Kong 44

2.2.3 Legal and Regulatory Environment 45

2.2.4 Code on Corporate Governance Practices 47

2.2.5 Challenges of Corporate Governance in Hong Kong 49

3 JAPAN 55

3.1 Country Analysis 55

3.2 Corporate Governance in Japan 55

3.3 Corporate Governance Laws in Japan 61

3.4 Corporate Governance Structures in Japan 62

3.5 The Regulatory Framework 66

3.6 Corporate Governance Codes and Guidelines 67

3.7 Challenges of Corporate Governance in Japan 68

3.8 Recent Japanese Corporate Governance Problems 69

4 CORPORATE GOVERNANCE IN MALAYSIA 74

4.1 Country Analysis 74

4.2 Regulation of Corporate Governance in Malaysia 74

4.3 Code on Corporate Governance 75

4.4 Companies Amendment Act 2007 80

4.5 Issue of Corporate Governance in Malaysia 82

5 SOUTH KOREA 87
5.1 Country Profile 87
5.2 Corporate Governance in South Korea 87
5.3 Flaws in Corporate Governance System of Korea 89
5.4 Corporate Governance Reforms in Korea 90
5.5 Corporate Law in South Korea 92
5.6 Code of Corporate Governance in Korea 94
5.7 Challenges of Corporate Governance in Korea 98
6 CORPORATE GOVERNANCE IN SINGAPORE 104
6.1 Country Analysis 104
6.2 Corporate Governance Framework in Singapore 104
6.3 Ownership Structure 105
6.4 Board Structure 105
6.5 Code of Corporate Governance 106
6.6 Concluding Remarks 121
7 CORPORATE GOVERNANCE IN THE MENA COUNTRIES 123
7.1 Introduction 123
7.2 Evolution of Corporate Governance 124
7.3 Specific Issues in Corporate Governance 125
7.4 Conclusion 133
7.5 Recommendations on Improving Corporate Governance 134
8 CORPORATE GOVERNANCE IN SAARC NATIONS 136
8.1 About SAARC 136
8.2 Pakistan 136
8.2.1 Introduction 136
8.2.2 Pakistan Debt Crisis of 1998 137
8.2.3 Corporate Governance in Pakistan 137
8.2.4 Ownership Pattern in Corporations 139
8.2.5 Board Structure 139
8.2.6 Corporate Governance Code 139
8.2.7 Implementation Challenges 141
8.3 Sri Lanka 141
8.3.1 Country Analysis 141
8.3.2 Corporate Sector 141
8.3.3 Corporate Governance Reforms 142
8.3.4 Challenges of Corporate Governance in Sri Lanka 143
8.4 Nepal 144
8.4.1 Country Analysis 144

		8.4.2 Market Profile	144
		8.4.3 Ownership pattern	144
		8.4.4 Board Structure	145
		8.4.5 Corporate Governance Code	145
		8.4.6 Implementation Challenges	146
	8.5	Bangladesh	147
		8.5.1 Country Analysis	147
		8.5.2 Market Profile	147
		8.5.3 Ownership Pattern	147
		8.5.4 Board Structure	148
		8.5.5 Corporate Governance Code	148
		8.5.6 Implementation Challenges	149
	8.6	Bhutan	149
		8.6.1 Country Analysis	149
		8.6.2 Market Profile	150
		8.6.3 Corporate Sector Regulations	150
		8.6.4 Board Structure	150
		8.6.5 Challenges	151
	8.7	Maldives	151
		8.7.1 Country Analysis	151
		8.7.2 Market Assessment	152
		8.7.3 Code of Corporate Governance	152
		8.7.4 Challenges	153
	8.8	Afghanistan	153
		8.8.1 Country Analysis	153
		8.8.2 Code of Corporate Governance	153
9	CORPORATE GOVERNANCE IN INDIA		157
	9.1	Genesis of Corporate Governance in India	157
	9.2	Regulatory Framework of Corporate Governance	167
	9.3	Corporate Governance Regulators	168
	9.4	Major Regulations on Corporate Governance	170
	9.5	Corporate Governance Practices in India	172
	9.6	Challenges to Promote Good Corporate Governance	198
		Case of Satyam Computer (2009)	201

CORPORATE GOVERNANCE PRACTICES IN ASIA

1
INTRODUCTION

1.1 Meaning and Significance of Corporate Governance

Corporate governance since its evolution as a concept has diverse approaches and interpretations[1]. It still does not have a universally settled meaning and a theoretical base. The Cadbury Committee of the U.K. defines corporate governance as, 'the system by which companies is directed and controlled'. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting. Corporate governance is, therefore about what the board of a company does and how it sets the values of the company, and is to be distinguished from the day to day operational management of the company by full-time executives. 'Corporate governance is about maintaining an appropriate balance of accountability between three key players: the corporation's owners, the directors whom the owners elect, and the managers whom the directors select. Accountability requires not only good transparency, but also an effective means to take action for poor performance or bad decisions'[2].

Corporate governance is set of processes, customs, policies, laws, and institutions affecting the way a corporation is directed, administered or controlled. It also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The domain of corporate governance is wide as it includes multifarious activities and practices in directing and controlling a firm. Corporate governance is shaped both by the internal and external mechanisms. The internal mechanisms include the ownership structure of the firm, the board of directors, the auditor and the audit committee, other committees of the board like nomination committee, remuneration committee. These internal mechanisms are shaped by the general laws and regulations; efficiency of legal and regulatory processes; customs and

[1]Adopted from Anil Kumar (2012) *Corporate Governance: Theory and Practice*, International Book House, New Delhi

[2]Mary L. Schapiro, Chairperson, Securities and Exchange Commission, USA, Address to Transatlantic Corporate Governance Dialogue - September 17, 2009.

traditions; market for corporate control; ownership patterns, political stability, and global standards.

According to James D. Wolfensohn, President of World Bank, “Corporate Governance is about promoting corporate fairness, transparency and accountability.” Corporate Governance is more a way of business life than a mere legal compulsion. There is nothing laudable about complying with conditions/practices, which the companies are forced to adopt through the process of legal prescription. Of course, companies must focus on their core objective of earning profits, but the earning and sharing of profits needs to be aligned with the expectations of stakeholders. The investors tend to value and remain loyal to organizations having established credentials for making efforts aimed at benefiting various categories of stakeholders. Adoption of distinct corporate governance practices distinguishes a company from ordinary companies, which are content merely with complying with prescribed legal requirements. The companies adopting distinct corporate governance practices stand out from others.

The forces of globalization and privatization unleashed a cult of equity investment around the world. The capital needs of companies are no longer met domestically and this has led to internationalisation of world capital markets. A large number of companies from both developed and developing economies trot the globe to peddle their securities. In such a competitive scenario it is important not only to win but also to retain confidence of the investors. The significance of good corporate governance in attracting investors has gained recognition, albeit slowly. Empirical research which examined the mechanism(s) of corporate governance and related that with the firm performance has led to an increasing recognition that good governance practices enhance the performance of company and boosts up the investors` confidence. Studies have revealed that markets and investors take note of well governed companies and reward them with higher valuation. In fact, the McKinsey Survey (2002) covering companies from emerging markets such as India, Malaysia, and South Korea etc. found that companies that adopted good governance practices enjoyed higher markets valuation and investors were willing to reward them with a premium which was as high as 28 percent per share. International institutions such as the World Bank and the OECD have strongly advocated the adoption of corporate governance practices to promote the economic growth.

Many Asian countries are the emerging markets where corporate governance system is undeveloped. Corporate governance received much attention in Asia following the Asian crisis of 1997 which exposed the weaknesses in corporate governance systems in East Asian countries. The opening up of the Asian economies, slowing of the Japanese companies and scams such as Satyam, Daweoo Motors, Olympia also serve as the impetus to reforms in corporate governance.

1.2 Model of Corporate Governance in Asia

The model of corporate governance in most Asian countries- Singapore, Malaysia, Korea, Thailand, India, Hong Kong and Middle East countries, is that of hybrid type. The models in these countries contain basic elements of the market model (Anglo-Saxon), dimensions of the bank model (Germany), and certain unique characteristics of their own. In most of these countries the family dominance is a paramount feature of corporate governance. Families hold large ownership stakes in the companies, form a pyramid of the affiliated companies to exercise control, and often have a close relationship with the banks and government bodies to garner support for family interest. The capital market in these countries is not well developed. Often, the legal and regulatory framework is not adequate in most of these countries to provide protection to the minority shareholders and creditors. In countries with sound legal system, implementation marred with slow legal process and rampant corruption impairs the effectiveness[3].

Many families have developed the business from its inception. Initially, family businesses were set up with the internal funds. As the enterprises grew with time, the role of banks and outside equity became important as suppliers of funds. But neither the banks nor the outside equity shareholders exert control over the family enterprises. This is often on account of weak regulatory framework and apathy of the investors which is ingrained in the cultural milieu of the countries. In general the business families are taken in high esteem in these countries recognizing their role in the economic development of the country. Most of the families controlling the conglomerate of firms secure their control via complex ownership structures such as pyramid, cross-shareholding or inter-locking directorships. These structures allow the controlling families to exercise a great deal of control over the companies despite small shareholding. In many instances, controlling shareholders which are families have control rights in excess of their cash flow rights.

In this model, the separation of ownership and control does not exist as the controlling families directly or indirectly participate in day-to- day operations of the companies. Controlling families appoint their family members or close associates as the CEO or the MD. There are cases where directors of such companies manage the affairs of the companies as full-time executives or as the sole proprietors. The boards are usually staffed with family members. Outsiders may be involved in the boards more to meet the regulatory requirement or to add ornament value to the boards. The duties of directors are stipulated in the laws of most Asian countries but it is given low priority. The boards of directors in family firms do not have significant role in the governance of companies or oversight over the executives. The role of directors is subservient to the family interest. With reforms underway in most of these countries, independent directors have been introduced to the family dominated boards. However, the role of independent directors has not taken a desired shape.

[3]Adopted from Anil Kumar (2012) *Corporate Governance: Theory and Practice* International Book House, New Delhi

Banks and other financial institutions provide finance to family owned and managed companies but do not exercise much control over the firms. Although in some countries, financial institutions and banks appoint their nominees on the boards of invested companies, such nominees directors more often are passive participants in board processes. The financial institutions vote with their feet instead of monitoring the assisted companies. Most of family-owned companies have low free float. The outside shareholders are neither organised nor inclined to challenge the families managing the affairs of the companies. The stock market is also not well-developed and market for corporate control is non-existence.

The governance system of family-based model is based on block-holder governance wherein majority of share capital is concentrated in the hands of one family or a few large investors. Controlling shareholders/ families have high incentive to extract private benefits through related party transactions between affiliated companies. Owners also indulge in transferring wealth from one company to another by selling assets at lower than market prices. There is diversion of funds of companies to family interest. Through pyramid and cross-holding structures, families gain wealth by setting unfair terms for intra-company transactions. This gives rise to conflict of interest between the controlling and minority shareholders. In many Asian and Middle East countries, the legal protection to minority shareholders is either non-existence or ineffective. Families in these countries more often expropriate the minority shareholders' interest. So the agency problem in family-based model of corporate governance is principal-principal conflict different from principal-agent conflict of market-based model.

The family-based model of corporate governance fills the market mechanism monitoring gaps. The family provides an effective control over the companies. The family business is less driven by the short term outlook. It also creates wealth although for the family to be handed down to the next generation. The family model poses certain challenges other than the expropriating the minority interest. The entrepreneurship and skills of the founder may not be replicated down the generation. It is often said that the first generation founds the business, the second generation builds it and the third generation dissipates it. Further, there may be tensions within the business leading to divisions. Diverse views within the family regarding running of the family business may hamper the smooth functioning of the company. Many family concerns in some jurisdictions have formed family councils consisting of family members to resolve the contentious issues in the best interest of the family and the company. The bigger challenge in this model is to incorporate sound corporate governance practices and to manage the companies by the professional managers in view of complexities of modern business.

Unitary board structures predominate in Asia; however China and Indonesia have dual board structures while Taiwan allows companies to choose between dual board and unitary board. Board structures are usually defined by company law and/or the individual company's Articles of Association.

In Malaysia, many of the listed companies are family-owned or controlled. The founder families have concentrated ownership and the founders or their descendants exert strong control over the companies. Shareholders who are outside the family have rights enshrined in laws based on British common law but the board is not much responsive to their aspirations. In South Korea, likewise the family conglomerates known as *chaebols*exercise considerable power through cross-holding of shares in various companies.

The board structure is unitary in South Korea but the ineffective board and lack of transparency and disclosure have been the impediments of good corporate governance. The quality of corporate governance has improved considerably in many East Asian countries including South Korea since the 1997 financial crisis.[4]

The corporate governance system in Hong Kong has strong lineages with the British company law and amongst the most advanced in Asia. Although majority of listed companies are family-controlled, Hong Kong is much ahead of Korea and most other Asian countries in professionalism of its management[5]. Both the banks and equity markets are much stronger than other Asian countries. Hong Kong has a strict monetary authority and reasonably strong financial system[6]. The stock market is also well developed in Hong Kong. The board of directors is unitary and the regulations require a minimum three independent non-executive directors on the board. The family-centric board, however do not see much value in them. The corporate governance in Hong Kong is plagued by lack of corporate transparency particularly on connected party transactions and directors' remuneration, weak protection for minority protection and weak enforcement of rules[7].

The corporate governance model of Middle East countries—Kuwait, Saudi Arabia, UAE is marked by family-owned non-listed companies with small number of shareholders. The majority shareholders actively participate in the management of companies, although rely on bank finance for expansion and growth[8]. There is no market for corporate control. The investment culture in these countries is dominated by family investment and banks. The equity culture is missing in many of these countries. There is no separation of ownership and control in the system of corporate governance in vogue in these countries. The board structure broadly one-tiered is dominated by controlling shareholders representing the family interest[9]. Board members are often controlling shareholders' relatives or former high ranking government employees. Separation of board and management is not visible in many of the companies of these countries as the board does not usually have non-executive or independent directors.

---

[4] Kim and Kim (2007)
[5]Haider (1999)
[6] Op. cit
[7] Ho S S M (20080 'Hong Kong system of corporate governance' in A Naciri
[8]Naciri A (2008) The MENA countries national systems of CG
[9] Op cit

1.3 Ownership and Control Structures

Concentrated ownership of publicly traded companies is an economic reality for most Asian economies as nearly two-thirds of public companies have a controlling shareholder (Khan 2003, Morck et al., 2005). Credit Suisse, 2011 report on Asian family businesses is presented the percentage of shareholdings by families in Asian countries which is predominant in the range of 58-67 % in Asian countries with the exception of China where state ownership is still prevalent.

Family businesses in Asia, 2011

Country	Ownership by Families
India	67%
Thailand	66%
Singapore	63%
Malaysia	62%
Indonesia	61%
Hong Kong	62%
South Korea	58%
Chinese Taipei	35%
China	13%

Source: Credit Suisse, 2011 'Asian Family Businesses Report'

This concentrated ownership structure presents both opportunities and risks. The majority owners have the incentive to monitor the company and/or management closely and carefully as they have invested substantial amount of money in the companies. Their controlling power which most often is derived from the voting rights enables them to monitor performance, implement strategies to effect changes and timely decision-making to capitalize emerging opportunities. Controlling owners are usually driven by long-term investment horizon and look for the long-term strategy for the company.

Although controlling owners can potentially reduce some agency costs compared to companies with dispersed ownership, the same influence also creates other risks. These risks are commonly referred to as 'private benefits of control' that may put non-controlling shareholders at a disadvantage. This includes, for example, an insider extracting from the company assets, information and opportunities, at prices or conditions more favourable to them than in an arm's-length transaction.

1.4 Issues of Corporate Governance in Asia

Corporate governance has travelled a long way across the Asian economies after adoption of structural reforms programmes in 1990s and after the 1997 financial crisis engulfed the whole of East Asian. The improvements are clearly discernible in the legal and regulatory framework by amendments in the company and securities laws, regulations, listing rules and corporate governance codes. Some Asian countries including China, Hong Kong, Malaysia, Singapore, and

India have overhauled their Companies Act to contain regulations on corporate governance most of which are either at par and even exceed the global standards. While codes of corporate governance have been formulated in almost all Asian jurisdictions including least developed countries like Bangladesh, most other Asian countries have revised the codes or are in the process of revising their codes.

References

Anil Kumar (2012) *Corporate Governance: Theory and Practice,* International Book House, New Delhi

Credit Suisse (2011) 'Asian Family Businesses Report'

FiannaJurdant (2014) 'Board Nomination and Election: A Comparative View' In *Hong Kong Corporate Governance: A Practical Guide* (ED) Benita Yu and Laurence Rudge Slaughter and May, White Page Ltd

Khan, Haider (1999), 'Corporate Governance in Asia: What's Right and What's Wrong?' ADBI, Tokyo

Khan, Haider (2003), 'Corporate Governance Reforms Singapore and Hong Kong', Discussion Paper No F228CIRJE, Graduate School of Economics, University of Tokyo

Ho S S M (20080 'Hong Kong System of Corporate Governance' in ANaciri (Ed.) *Corporate Governance Around the World,* Routledge, Oxon

Kim, E. Han and Kim, Woochan(2007) 'Corporate Governance in Korea: A Decade after the Financial Crisis',*U of Texas Law, Law and Econ Research Paper No. 123*

Mary L. Schapiro, Chairperson, Securities and Exchange Commission, USA, Address to Transatlantic Corporate Governance Dialogue - September 17, 2009.

Morck, Randall, Daniel Wolfenzon, and Bernard Yeung (2005). "Corporate Governance, Economic Entrenchment, and Growth." *Journal of Economic Literature* 43:3, 655-720.

Naciri A (2008) 'The MENA Countries National Systems of CG' in A Naciri (Ed.) *Corporate Governance Around the World,* Routledge, Oxon

2

Corporate Governance in China and Hong Kong

2.1 People's Republic of China

2.1.1 Country Analysis

China has moved from a centrally planned closed economy to a market-oriented one since the late 1970s with the reforms phasing out of collectivised agriculture, and liberalisation of prices, fiscal decentralisation, increased autonomy for state enterprises, creation of a diversified banking system, development of stock markets, rapid growth of the private sector, and opening to foreign trade and investment. In 2010 China became the world's largest exporter, and in 2012 it stood as the second-largest economy in the world after the US. Notwithstanding the tremendous growth, the China faces numerous economic challenges, including:

(a) per capita income below the world average;
(b) high domestic savings rate and correspondingly low domestic demand;
(c) sustaining adequate job growth for a vast population of migrants and new entrants to the work force;
(d) corruption and other economic crimes;
(e) deteriorating environment - notably air pollution, soil erosion, and the steady fall of the water table; and
(f) containing social strife related to the economy's rapid transformation.

2.1.2 Corporate Governance in China

Corporate governance in China has undergone significant changes during the past three decades as the Chinese economy has liberalised and developed over these years. Until 1978, most Chinese enterprises were state-owned. A major characteristic of the state-owned enterprises was that these were administration-driven having unified and collective governance. Enterprises were mainly managed by "administrative" means and ranked in accordance with the levels of government concerned and the size and affiliation of the company. Corporate production plans were not decided by the market, but by the government according to a national plan and sub-plans. Business performance was measured by the number of planned targets that were met, rather than by the market value realised. Political entitlement was the major incentive for managers and employees. Managers had no independence in business activities, nor could they share the results of successful business operations, and therefore lacked the drive to improve the

performance. As managers' autonomy and corresponding administrative ranks were mainly decided by the size and economic resources of their companies, they were inclined to expand the size of the enterprise while paying little attention to its business performance.

The first significant change came in 1980 when state owned enterprises and collectively owned enterprises in rural areas began issuing shares to the public and this spread rapidly to cities which led to the creation of national stock exchanges in Shanghai and Shenzhen[10]. The stock exchanges were started with listing of just 14 companies. Companies listing and trading volumes rapidly increased in line with China's tremendous economic growth. In July 1992, the State Council formulated and promulgated the Regulation on the Transformation of Operational Mechanisms of Industrial Enterprises Owned by the Whole People, delegating 14 independent powers of operation to state owned enterprises (SOEs). The autonomy by the new regulations accelerated the pace at which SOEs moved from a planned economy to a market economy. China Securities Regulatory Commission (CSRC) was set up in 1992 to provide regulatory oversight of the burgeoning listing and fast expanding capital markets.

Since the establishment of CSRC, more than 300 laws and directives concerning securities market have been issued in mainland China[11]. The Company Law was introduced in the year 1993 which prohibited self-dealing by executives and directors and delegated merger approval to the shareholders. Securities Law of 1998 strengthened the CSRC's supervision of the equity market and its power to penalise self-dealing. By the year 2000 China had created a capital market that measured up reasonably well as all 98 % of state and company held shares have become tradeable, eliminating the privileged ownership rights that had initially been reserved for state and company shareholders. China opened its equity market to foreign institutional investors in 2003, and in 2005 it initiated a programme to convert untraded state and company held shares into tradeable securities.

Due to China's market reforms and accelerated growth, the Chinese exchanges expanded rapidly- by the year 2008 the Shenzhen Stock Exchange listed 540 companies with a total market value of RMB 1 trillion and Shanghai exchange listed 1172 companies with a value of RMB 15 trillion[12].

The Company Law and the Securities Law were revised with effect from January 1, 2006 to strengthen minority shareholder rights by:

- Giving rights to shareholders to appoint directors and/or supervisors.
- Imposing a stricter duty of care on directors, supervisors, and senior management.

[10]Neng Liang and Michael Useem 'Corporate Governance in China' (www.ceibs.edu)
[11] Thomas W. Lin (2004), 'Corporate Governance in China: Recent Developments, Key Problems and Solutions' *Journal of Accounting and Corporate Governance,* Vol. 1 June
[12]Neng Liang and Michael Useem 'Corporate Governance in China' (www.ceibs.edu)

- Granting shareholders the right to bring a derivative suit or direct suit against directors, supervisors, and senior management.
- Introducing the concept of 'piercing the corporate veil,' enabling courts to look beyond the principle of limited liability.
- Increasing minority shareholder protection by granting shareholders the right to check and copy the company's account books and minutes of the meetings, allowing share buybacks, and granting shareholders the right to petition for liquidation of the company.

2.1.3 Code of Corporate Governance

China Securities Regulatory Commission (CSRC) and State Economic and Trade Commission developed the first Code of Corporate Governance for Chinese Listed Companies in 2002 which follows OECD Principles of Corporate Governance. The Code promotes basic governance principles and sets out a basic code of conduct and professional ethics for directors, supervisors and senior management of listed companies. The Code of Corporate Governance applies to all listed companies in Mainland China and has become the standard measure in China with which to evaluate whether or not a listed company has established strong corporate governance practices. The broad provisions of the Chinese Code are as follows:

Shareholder Rights

Shareholder rights are important for listed companies in Mainland China and are protected by law, administrative regulations and the company's own articles of association. The Code states that all shareholders especially minority holders are to enjoy equal rights based on their shareholdings. Each share should be entitled to the same rights and responsibilities as any other share. As per the code provisions one-share, one-vote standard must be observed at annual general meetings (AGMs). Shareholders have the right to participate in major corporate decisions as set out in the laws and articles of association of the companies. The Code requires a listed company to lay down the rules and procedures on convening and voting at the shareholders meetings. Shareholders can nominate representatives to attend AGMs on their behalf. In turn, representatives may submit a power of attorney to the company in order to exercise their voting rights. All resolutions must be approved by a majority vote of the shareholders attending the meeting. However, resolutions must be approved by at least two-third of all votes in case of: amendments to the articles of association; an increase or decrease in registered capital; change a merger, spin-off or dissolution. In the case of state-owned enterprises that do not convene shareholder meetings, the State-Owned Assets Supervision and Administration Commission and/or its branch organizations exercise the rights of shareholders.

In addition, institutional shareholders, the Code asks, to assume a role in the appointment of directors and other major decisions of the company.

With respect to transactions with related shareholders, in China, a listed company's assets are solely owned by the company. A listed company should take measures to prevent shareholders or related parties from transferring funds, fixed assets or other resources. Listed companies are not allowed to provide guarantees to shareholders on related parties.

Boards of Directors

The Chinese Company Law provides setting up of a board of directors for a limited liability company (LLC) and a joint-stock company (JSC) with three to thirteen directors for LLC and five to nineteen directors in JSC. Directors' terms are determined by the Articles of Association and do not exceed three years, though terms may be renewed. Boards of directors are directly accountable to shareholders. Board meetings are held at least twice each year with a quorum of at least half its members. Board resolutions must be passed by a majority of directors. A one-share, one vote standard prevails for board resolutions on general matters or on appointment or termination of management. Listed companies are expected to appoint independent directors, each of whom should be independent from the company's operations and its major shareholders, and should not play a role other than that of director. Independent directors have fiduciary obligations to the company which should be fulfilled with due care while paying attention to the legitimate rights and interests of minority shareholders.

In addition, Code contains provisions on transparent procedure for election of directors; cumulative voting system for listed companies having more than 30% ownership by controlling shareholders; training of directors; and responsibilities of directors.

For state-owned enterprises, directors are elected for terms of not more than three years. Board members consist of representatives assigned by the State-Owned Assets Supervision and Administration Commission and/or its branch organizations as well as employee representatives elected by the company’s employees.

Board Committees

All listed companies in Mainland China are expected to establish an audit committee, subject to shareholders’ approval. Audit committee members are directors, and independent directors should form a majority of its members. At least one independent director of each audit committee should have relevant accounting qualifications. China's Code of Corporate Governance defines the roles and responsibilities of an audit committee. The Code also requires establishment of nomination and remuneration committees with a majority of independent directors.

Supervisory Committees

Supervisory committees, required for all limited companies, to monitor the directors and management, should have at least three members consisting of representatives of shareholders and employees. The proportion of employee representatives should not be less than one third of the total. Directors and senior management may not serve as supervisors. Supervisory committees are required to operate by majority vote and meet at least once every six months. Meetings operate by majority vote. Supervisory committees have fiduciary obligations to the company which should be fulfilled with due care while paying attention to the legitimate rights and interests of minority shareholders.

Supervisory committees of state-owned enterprises are composed of at least five members, with at least one-third of its members comprised of employee representatives elected by the company's employees. Other supervisory committee members are assigned by the State-Owned Assets Supervision and Administration Commission and/or its branch organisations to three year terms, though terms may be renewed.

Remuneration and Evaluation

Listed companies are expected to establish remuneration and incentive systems as well as a mechanism to evaluate the performance of directors, supervisors and managers. Evaluation of directors and management should be led by the board of directors or a remuneration committee of the board of directors. For independent directors and supervisors, evaluation can be conducted by a combination of self-assessment and collaborative evaluation. The terms of directors' remuneration are proposed by the board and are submitted to shareholders for approval. Executive remuneration is approved by the board and is required to be disclosed.

Information Disclosure and Transparency

The Code lays down information disclosure requirements of companies in three broad areas:

- on-going information disclosure- accurate and complete timely disclosure of information as required by the laws and regulations;
- disclosure on corporate governance- structure of board of directors and supervisory committee and board committees, evaluation of board of directors and supervisory committee including the attendance record of the board and committee members, and the deviations/gaps between company's corporate governance and the Code, the reasons thereof and plans to bridge the gaps;
- disclosure on controlling shareholder(s)- information about each shareholder who owns a larger percentage of shares in the company and company's actual controllers.

2.1.4 Distinctive Features of Chinese Corporate Governance

Highly Concentrated Ownership

Ownership in China's listed firms is highly concentrated. Of the 1,602 companies listed on the Shanghai and Shenzhen stock exchanges in August 2008, the single largest owner held 36 per cent of an average company's shares, the top three owned 49 per cent and the biggest five controlled 52 per cent[13]. In terms of the shareholding structure, the shareholding concentration level of the top 100 listed companies remained very high.

Many listed Chinese companies have a pyramid ownership structure wherein firms are owned or controlled by an unlisted holding company, and many of the listed firms in turn control other listed companies. A study in 2006 by the Shanghai Stock Exchange revealed that the practice of tunneling and mis-appropriation of funds through pyramid structure is widespread- of the 1,377 firms studied, 35 per cent had misappropriated to their parent companies funds totaling RMB 48 billion[14].

Strong State Ownership

Most companies in China are either re-structured state owned enterprises (SOEs) or founded by legal persons[15]. Despite a process of privatisation of state-owned enterprises over the last three decades, government agencies have maintained a high level of ownership and thus strong influence over many of the country's publicly listed firms. State-owned or state-controlled enterprises were responsible for 31 per cent of China's GDP in 2007, and the Shanghai Stock Exchange reported that the government held 51 per cent of its listed shares[16]. As per the Corporate Governance Assessment Summary Report on the Top 100 Chinese Listed Companies for 2012 by Proviti (Risk & Business Consulting), state-owned shareholders still dominated among the top 100 listed companies. The largest, second largest and third largest shareholders in 84%, 49% and 39% of the top 100 listed companies were state-owned entities respectively. The percentage of companies whose largest shareholder was a private company was only 13%.

The state shares and legal person shares are not traded on the securities markets means that more than 60% of the outstanding shares have been excluded from the market. This has reduced the liquidity of the secondary market in China.

---

[13]Neing Liang and Michael Useem 'Corporate Governance in China'
[14]Neing Liang and Michael Ussem
[15] S.S. M. Ho 'The Chinese National System of Corporate Governance' In *Corporate Governance Around the World* by A Nachiri Ed. Routledge 2008

[16]Neing Liang and Michael Useem

Continued State influence on business operations of State-Owned Enterprises continues to exert influence on the overall management of more than two-thirds of listed companies. This creates an environment where the loyalties of directors and senior managers may lie almost entirely with the majority shareholder (the state) to the detriment of minority shareholders. In spite of dominant shareholding in many Chinese enterprises, the state does not exercise effective control over the companies. The managers who are have the patronage of the ruling political party wield control over the companies with little incentive to operate the company in the interest of all the shareholders.

The agency problem in China is thus different from South-Asian family businesses. While in South-Asian companies it is between families who are the dominant shareholders and minority shareholders, in China it is multi-parties i.e. major shareholders which is State, directors, supervisors, managers and smaller shareholders[17].

Board Structure

China has adopted a two-tier board structure akin to the German system of an executive board and a supervisory board to oversee the executive board. However, the supervisory board in China also known as the supervisory committee is an internal supervisory body different from the supervisory board of Germany which has the predominance of outsiders. Chinese supervisory boards are required to have at least three members, and one third of the members must be employee representatives. In recent years, there is a common trend among the top 100 Chinese listed companies that their boards of supervisors are mainly composed of external personnel rather than internal personnel[18].

In principle the supervisory board monitors the directors and management, but in practice many supervisory board members are state representatives, party officials or labour union leaders who do not have business experience. Consequently they are unable to monitor the board of directors and largely ditto the decisions of directors and management.

The supervisory board in China has so far not played any effective governance role. Supervisors are not involved in the selection of directors and managers and have no means of disciplining them. In many companies, the supervisory board duplicates the authority of the board of directors but without corresponding responsibilities.[19] This duplication and overlap of functions creates redundancy in the corporate governance structure. Further, it dilutes the authority of the board of directors and increases administrative costs for companies.

---

[17] S.S. M. Ho 'The Chinese National System of Corporate Governance' In *Corporate Governance Around the World* by A Nachiri Ed Routledge 2008

[18] As per the Corporate Governance Assessment Summary Report on the Top 100 Chinese Listed Companies for 2012 by Proviti (Risk & Business Consulting)

[19] Thomas W. Lin (2004)

However, recent revisions to the Company Law have clarified the role of the supervisory board in Chinese companies, but a number of shortcomings still remain. As per the Corporate Governance Assessment Summary Report on the Top 100 Chinese Listed Companies for 2012 by Proviti (Risk & Business Consulting) there were still many insufficiencies in practice; only 44 companies provided clear and written "Board of Supervisors Organization and Rules of Procedure"

Strong Shareholder Rights

The revised Company Law 2006, of China requires greater disclosure of information to shareholders. Besides the rights of shareholders to elect directors at shareholder meetings, shareholders also have access to company charters, shareholder lists and the minutes of meetings of both the supervisory board and the board of directors. Provisions have been made in the Company Law to protect the interest of minority shareholders. These include: formal procedures for related-party transactions; right to convene shareholders' meetings, preside over those meetings and moving motions. Cumulative voting system to elect directors has also been provided for electing directors and members of the supervisory committee.

Corporate Social Responsibility

Unlike most other countries in the world barring India, Chinese norms place emphasis on corporate social responsibility. The Company Law 2006 requires a company to 'observe social norms and assume social responsibility while conducting businesses. The stock exchanges in China also mandate listed companies to consider the interest of creditors, community development and environmental protection while maximizing shareholders' value.

Low Ethical Standard

Lack of creditability of financial information and market transactions is a serious problem in China. Although the Chinese regulators have made many efforts to improve transparency and enforcement over the last ten years by making provisions in the Company Law, Stock Exchange Disclosure Requirement Rules and the Listing Rules, disclosure practices in China remain vague owing to weak enforcement. Cheating, frauds and manipulation are the mal-practices quite common in China. Information disclosures by companies in many cases are not timely and accurate. A common complaint among investors in China is that financial information on company performance is either not available or, if provided, it lacks reliability.

Many Chinese chartered accountants do not have enough knowledge about international accounting practices and are not well equipped with computer skills due to a lack of proper training. Moreover, Chinese audit firms have many problems in their operations because of lack

of sound supervision mechanisms, which gives rise to serious fraud cases in the securities market [20]. No surprise, China is ranked amongst the bottom countries in terms of quality of corporate governance.

The most significant issue with respect to corporate governance in China is enforcement of the many provisions that already exist in the law. Even though China has adopted many of the principles of corporate governance followed in the U.S. and EU, there is no guarantee that SOEs and public companies will implement them in the best interests of investors given the critical role of the state representative-shareholders and the government.

"Assessment results of information disclosure for the 2012 top 100 listed companies indicated that the adequacy and procedures of information disclosure at listed companies in China showed scope for improvement. For example, there was inadequate disclosure on non-financial information and off-balance sheet information; disclosure on operational risks was insufficient; annual reports of some companies were just for compliance purposes and without substantial content".

Executive Remuneration

Over the past few years, remuneration of directors, supervisors and senior executives is rising rapidly. As per the Corporate Governance Assessment Summary Report on the Top 100 Chinese Listed Companies for 2012 the executive remuneration at the top 100 listed companies showed an increasing trend. Such an increase in cash and bonus reward was not aligned with shareholders' value. Since the stock market in China was not performing well in the past few years, the Chinese companies did not respond positively to the stock-based incentive measures introduced by the CSRC.

2.1.5 Corporate Governance Practices of Listed Companies in China

1. CASE Of LENOVO

BOARD OF DIRECTORS

The board of directors and the management of Lenovo Group Limited strive to attain and uphold a high standard of corporate governance and to maintain sound and well-established corporate governance practices for the interest of shareholders and other stakeholders including customers, suppliers, employees and the general public. The Company abides strictly by the governing laws and regulations of the jurisdictions where it operates and observes the applicable guidelines and rules issued by regulatory authorities. It regularly undertakes review on its corporate governance system to ensure it is in line with international and local best practices.

[20] Thomas W. Lin

The Company has maintained on its website and Hong Kong Exchanges and Clearing Limited's website an updated list of its directors identifying their roles and functions and whether they are independent non-executive directors. Independent non-executive directors are also identified as such in all corporate communications that disclose the names of directors of the Company.
Mr. Zhu Linan and Mr. Zhao John Huan, non-executive directors, also serve on the board of directors of Legend Holdings Limited, the controlling shareholder of the Company. Except for the relationships (including financial, business, family, and other material and relevant relationships) as detailed above and in the biographies of directors set out on pages 96 to 98 of the Company's 2012/13 Annual Report, there are no other relationships among the Board to the best knowledge of the Board members as of May 23, 2013.

Chairman and Chief Executive Officer The Chairman leads the Board in the determination of its strategy and in the achievement of its objectives and ensures that all directors are properly briefed on issues arising at Board meetings and receive adequate, complete and reliable information in a timely manner. The CEO has delegated authority from the Board to take direct charge of the Company and its subsidiaries on a day-to-day basis and is accountable to the Board for the financial and operational performance of the Group. Both the Chairman and CEO positions are currently held by Mr. Yang. The Board believes that the current governance structure, with a combined Chairman and CEO and a vast majority of non-executive directors, provides an effective balance of power and authority for the management of the Company in the best interests of the Company at the present stage.

Lead Independent Director As a means of enhancing corporate governance of the Company, Mr. William O. Grabe, an independent non-executive director of the Company, has been appointed by the Board as the lead independent director of the Company on May 23, 2013. The Lead Independent Director is not an executive position in the Company and does not have any management role in the Company or any of its subsidiaries.
As the Lead Independent Director, Mr. Grabe has the following roles: (1) to chair the Nomination and Governance Committee meeting and/or the Board meeting when considering (a) the combined roles of Chairman and CEO; (b) assessment of the performance of Chairman and/or CEO; (2) to call and chair meeting(s) with all non-executive directors at least once a year on such matters as are deemed appropriate and provide feedbacks to Chairman and/or CEO; (3) to serve a key role in the Board evaluation process; (4) responds directly to shareholders and other stakeholder questions and comments that are directed to the Lead Independent Director or to the independent non-executive directors as a group, when appropriate; (5) if requested by major shareholders, ensures that he is available, when appropriate, for consultation and direct communication; and (6) to perform other duties as directors may designate.

Independence of Non-executive Directors The current composition of the Board, with a high proportion of independent non-executive directors, ensures and provides strong and meaningful oversight over management. The independent non-executive directors do not participate in the day-to-day management of the Company and do not engage in any business dealing or other relationships with the Group (other than in situations permitted by the applicable regulations) in order to ensure that they remain truly capable of exercising independent judgement and act in the best interests of the Group and its shareholders. Further, the Board is satisfied and assured that no individual or group of directors has unfettered powers of decision that could create a potential conflict of interest.

Appointment and Election of Directors

There is a formal and transparent procedure for the appointment of new directors to the Board, the primary responsibility of which has been delegated to the Nomination and Governance Committee. The Nomination and Governance Committee is composed of the Chairman and two independent non-executive directors. This composition ensures that any decisions made are impartial and are in the best interest of the Company.

On May 23, 2013, the Board adopted the Board diversity policy (the "**Diversity Policy**") which relates to the selection of candidates for the Board. The Diversity Policy was adopted to ensure that diversity in its broadest sense continues to remain a feature of the Board. The Nomination and Governance Committee's assessment of the candidates includes, but is not limited to, consideration of the relevant knowledge and diversity of backgrounds, skills, experience and perspectives that would complement the existing Board. The Company has set out the following objectives for fiscal year 2013/14:

Board appointment process The structure, size and composition (including, for example, gender, age, and length of service) of the Board will be reviewed from time to time by the Nomination and Governance Committee to ensure that the Board has a balance of skill and expertise for providing effective leadership to the Company. The Nomination and Governance Committee also ensures that candidates satisfy the requisite skills and core competencies to be deemed fit and proper, and to be appointed as director. The nomination process involves the following six stages:

Board tenure In accordance with the articles of association of the Company, all directors are subject to retirement by rotation. At each annual general meeting, one-third of the directors for the time being shall retire from office. The retiring directors shall be eligible for re-election. New appointments either to fill a casual vacancy or as an addition to the Board are subject to re-election by shareholders of the Company at the next following annual general meeting of the Company.

All non-executive directors (including independent non-executive directors) have entered into letters of appointment with the Company for a term of three years. Their terms of appointment shall be subject to retirement from office by rotation and re-election at the annual general meeting in accordance with the Articles of Association.

The Company agreed that the independence of directors is an important principle of the Company. In line with the best practices on corporate governance, the Board adopted the principle that each term of an independent non-executive director of the Company shall not be more than three years and shall, subject to re-election by shareholders at any subsequent annual general meeting of the Company, be renewable for additional three-year terms up to a total of nine years. At the recommendation of the Nomination and Governance Committee, the Board may invite an independent non-executive director to serve for an additional three-year term extending up to a total of twelve years subject to re-election at any subsequent annual general meeting of the Company.

2. Suning Commerce Group Co., Ltd

Suning Commerce Group Co., Ltd., since its listing, has carried out modern enterprise systems actively, perfected corporate governance structure constantly, and paid attention to normalized operation strictly according to national laws and rules, as well as the requirements of related regulations of China Securities Regulatory Commission. The Company has set up stockholders' conference, board of directors, and board of supervisors according to laws, and further made clear the power-responsibility scope and working procedures of the stockholders' conference, board of directors, board of supervisors, and senior managers by formulating and perfecting the normative documents and internal systems, like the Rule of Procedure for Stockholders' Conference, the Rule of Procedure for the Board of Directors, the Rule of Procedure for the Board of Supervisors, the Detailed Rules for the Work of President, the Detailed Rules for the Work of Secretary to the Board of Directors, and the Major Investment and Financial Decision-making System. Meanwhile, in order to further perfect its governance structure, the Company has set up the Nomination Committee, Remuneration and Assessment Committee, and Audit Committee under the Board of Directors, further established and perfected the assessment and remuneration management systems aiming at the Company's directors and senior managers, and ensured the effective supervision of the Board of Directors on senior managers according to the requirements of relevant regulations like the Company Law, the Rules for Governance of Listed Companies, and the Guide for Protecting the Rights and Interests of Investors in Small- and Medium-sized Enterprise Boards.

The Company's Board of Directors is responsible for the Stockholders' Conference, and fulfills responsibilities according to related laws and rules, like the Company's Articles of Association, and the Rule of Procedure for the Board of Directors.

3. China Telecom Corporation Ltd. (Annual Report 2013)

The Company strives to maintain a high level of corporate governance and inherited an excellent, prudent and efficient corporate governance style and continuously improves its

corporate governance methodology, regulates its operations, improves its internal control mechanism, implements sound corporate governance and disclosure measures and ensures that the company's operations are in line with the long-term interests of the company and its shareholders as a whole.

As a company incorporated in the People's Republic of China (PRC), the Company adopts the Company Law, the Securities Law of the People's Republic of China and other related laws and regulations as the basic guidelines for the Company's corporate governance. As a company dual-listed in Hong Kong and the United States, the current Articles of Association are in compliance with the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited ("the Listing Rules") and the regulatory requirements for non-US companies listed in the United States, and these rules serve as guidance for the Company to improve the foundation of its corporate governance.

For the financial year ended 31 December 2013, except that the roles of Chairman and Chief Executive Officer of the Company were performed by the same individual, the Company has been in compliance with all the code provisions under the Corporate Governance Code as set out in Appendix 14 to the Listing Rules. In the Company's opinion, through supervision by the Board and the Independent Non-executive Directors, and effective control of the company's internal check and balance mechanism, the same individual performing the roles of Chairman and Chief Executive Officer can.

In 2013, the Company's continuous efforts in corporate governance gained wide recognition from the capital markets and the Company was accredited with a number of awards.

Overall Structure of the Corporate Governance

A double-tier structure has been adopted as the overall structure for corporate governance: the Board and the Supervisory Committee are established under the Shareholders' General Meeting. The Audit Committee, Remuneration Committee and Nomination Committee were established under the Board. The Board is authorised by the Articles of Association to make major decisions on the Company's operation and to oversee the daily management and operations of the senior management. The Supervisory Committee is mainly responsible for the supervision of the performance of duties by the Board and the senior management. Each of the Board and the Supervisory Committee is independently accountable to the Shareholders' General Meeting.

Shareholders' General Meeting

In 2013, the Company convened one Shareholders' General Meeting, the Annual General Meeting ("AGM") for the year 2012. The AGM held on 29 May 2013 reviewed and approved numerous resolutions such as the financial statements for the year 2012, Report of the

Independent International Auditor, proposal for profit and dividends distribution, authorisation to the Board for the formulation of a budget for 2013, appointment and remuneration of auditors, authorisation to the Board to issue debentures and appointment of a director. Since the Company's listing in 2002, at each of the Shareholders' General Meetings a separate shareholders' resolution was proposed by the Company in respect of each independent item. The circulars to shareholders also provided details about the resolutions. All votes on resolutions tabled at the Shareholders' General Meetings of the Company were already conducted by poll and all voting results were published on the websites of the Company and The Stock Exchange of Hong Kong Limited.

Board of Directors

As at 31 December 2013, the Board of Directors of the Company comprises of 13 directors with 7 Executive Directors, 1 Non-executive director and 5 Independent Nonexecutive directors. The Audit Committee, Remuneration Committee and Nomination Committee under the Board all consists solely of Independent Non-executive Directors.. Number of independent directors constitutes more than one-third members of the Board. The Chairman of the Audit Committee is an internationally renowned financial expert with expertise in accounting and financial management. The term of office for the fourth session of the Board lasts for three years, starting from May 2011 until the day of the Company's Annual General Meeting in 2014, upon which the fifth session of the Board will be elected.

In August 2013, the Company adopted the Board diversity policy. The Company believes that Board diversity will contribute significantly to the enhancement of the level of performance of the Company. In order to achieve a sustainable and balanced development, the Company views the increasing Board diversity as a key element for supporting its strategic goals and maintaining sustainable development. In determining the composition of the Board, the Company takes into account diversity of the Board from a number of perspectives, including but not limited to gender, age, education background or professional experience, skills, knowledge, duration of service, etc. All appointments made or to be made by the Board are merit-based, and candidates are selected based on objective criteria, giving full consideration to the benefits in terms of Board diversity. Final decisions are based on each candidate's attributes and the contributions to be made to the Board. The Nomination Committee oversees the to the Board. The Nomination Committee oversees the implementation of policies, reviews existing policies as and when appropriate, and recommends proposals for revisions for the Board's approval

The Company strictly complies with the Corporate Governance Code under the Listing Rules to rigorously regulate the operating procedures of the Board and its committees, and to ensure that the procedures of Board meetings are in compliance with related rules in terms of organisation, regulations and personnel. The Board responsibly and effectively supervises the preparation of financial statements for each financial period, so that such financial statements truly and fairly reflect the operational condition, the operating results and cash flows of the Company for such

period. In preparing the financial statements for the year ended 31 December 2013, the Directors adopted appropriate accounting policies and made prudent, fair and reasonable judgments and estimates, and prepared the financial statements on a going concern basis.

All members of the Board/Committees are informed of the meeting schedule for the Board/Committees for the year at the beginning of each year. In addition, all Directors will receive a meeting notification at least 14 days prior to the meeting under normal circumstances.

The Company Secretary is responsible for ensuring that the Board meetings comply with all procedures, related rules and regulations while all Directors can make inquiries to the Company Secretary for details to ensure that they have received sufficient information on various matters set out in the meeting agenda.

The Board meets at least four times a year. Additional Board meetings will be held as necessary. In 2013, the Board played a pivotal role in the Company's operation, budgeting, decision-making, supervision, internal control, organisational restructuring and corporate governance.

The Company convened four Board meetings, four Audit Committee meetings, one Nomination Committee meeting and several board and committee written resolutions were passed in this year.

At the Board meetings, the Board reviewed significant matters including the Company's annual, interim and quarterly financial statements, annual operational, financial and investment budgets, internal control implementation and assessment report, annual proposal for profit distribution, annual report, interim report and quarterly reports, connected transactions, continuing connected transactions and the annual caps applicable thereto and appointment and remuneration of auditors. All directors performed their fiduciary duties and devoted sufficient time and attention to the affairs of the Company.

Supervisory Committee

The Company's Supervisory Committee comprises six Supervisors, with one External Independent Supervisor and two Employee Representative Supervisors. On 19 August 2013, Mr. Mao Shejun retired as the Employee Representative Supervisor due to his age. On the same date, Mr. Tang Qi has been elected by the employees of the Company democratically as an Employee Representative Supervisor.

The principal duties of the Supervisory Committee include supervising, in accordance with the law, the Company's financials and performance of its Directors, managers and other senior management so as to prevent them from abusing their powers. The Supervisory Committee is a

standing supervisory organisation within the Company, which is accountable to and reports to all shareholders.

The Supervisory Committee holds meetings at least once or twice a year.

External Auditors

The international and domestic auditors of the Company are Deloitte Touche Tohmatsu and Deloitte Touche Tohmatsu Certified Public Accountants LLP, respectively. In order to maintain their independence, the non-audit services provided by the external auditors did not contravene the requirements of the Sarbanes-Oxley Act.

The Directors of the Company are responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with the International Financial Reporting Standards as issued by the International Accounting Standards Board and the disclosure requirements of the Hong Kong Companies Ordinance, and for such internal control as the Directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Investor Relations and Transparent Information Disclosure Mechanism

The Company establishes an Investor Relations Department which is responsible for providing shareholders and investors with the necessary information, data and services in a timely manner. It also maintains proactive communications with shareholders, investors and other capital market participants so as to allow them to fully understand the operation and development of the Company. The Company's senior management presents the annual results and interim results in Hong Kong every year. Through various activities such as analyst meetings, press conferences, global investor telephone conferences and investors road shows, the senior management provides the capital markets and the media with important information and responds to key questions which are of prime concerns to the investors. This has helped reinforce the understanding of the Company's business and the overall development of the telecommunications industry in China.

2.2 HONG KONG

2.2.1 Country Analysis

Hong Kong had been a British colony since 1841 till 1stJuly 1997 when it became a Special Administrative Region (SAR) of the People's Republic of China (PRC) having the status of a province. The traditional Chinese thinking dominates the entire population of Hong Kong although the institutions and legal framework is based on the British common law[21]. Hong Kong at present is a free market economy and a vibrant business hub of Asia. Its labour market is flexible and competitive. It levies excise duties on only four alcohol and tobacco related commodities. There are no quotas or dumping laws. At the same time, Hong Kong's limitation is that land natural resources are scarce, technology, equipment, food and raw materials and many resources have to be imported[22]. On account of these, the economy of Hong Kong is exposed to external economic shocks- Asian Crisis of 1997, Financial Crisis of 2008 and Euro Zone Crisis, although Honk Kong recovered quickly owing to increasing integration with China, through trade, tourism, and financial links. In the past decades, the economy had undergone several major structural transformations from an entrepot trading economy to light manufacturing, and more recently a service-oriented economy[23].

Heritage Foundation has ranked Hong Kong first in terms of economic freedom for 18 consecutive years starting from 1995 till 2012. The World Bank's Doing Business 2012 rated Hong Kong third in the world in the category of investor protection.

2.2.2 Corporate Governance in Hong Kong

The corporate sector of Hong Kong comprises of locally based and long established corporations which are linked to the British establishments, multinationals from the US, Europe and Japan. Small and medium enterprises (SMEs) account for more than 90% of the total business establishments in Hong Kong in terms of numbers, a majority of SMEs are in the import/export

[21] Jan Selmer and Corinna de Leon, 'Culture and management in Hong Kong SAR', in Malcolm Warner (ed), Culture and Management in Asia (2003) 48, 49-53

[22]Joongi Kim, 'A Forensic Study of Daewoo's Corporate Governance: Does Responsibility Lie Beyond the Chaebol and Korea?' (HGCY Working Paper Series, Hills Governance Centre

[23] Mick Carney and Howard Davis, 'From Entrepot to Entrepot via Merchant Manufacturing: Adaptive Mechanisms, Organizational Capabilities and the Structure of the Hong Kong Economy', in Chris Rowley and Robert Fitzgerald (ed) Managed in Hong Kong: Adaptive Systems, Entrepreneurship and Human Resources (2000) 13, 17-29)

business. Family control is a significant feature of Hong Kong listed companies with 66% being family owned[24]. Typically, a single extended family owns a significant proportion of the listed company's shares with the controlling family members or their nominees occupying senior management positions. In terms of corporate structures and management practices, it is a combination of borrowed ideas from developed economies and Chinese family values with a highly pragmatic mindset[25]. One study found that the top 15 families in Hong Kong held shares with market capitalization accounting for 84% of 1996 Gross Domestic Product[26].

Family domination and entrenchment in the shareholding ownership structure in Hong Kong has given rise to accusations of minority shareholder expropriations. In consequence, it presents a typical Asian agency problem of majority shareholders vs minority shareholders. Although family ownership is very common in Hong Kong as with other Asian countries, the market in Hong Kong is better developed owing to the presence of multinational companies that have to meet internationally accepted standards of best practice.

Over the past decade, the Stock Exchange of Hong Kong (SEHK) has been consistently within the top five listing markets in the world. The aggregate market capitalisation of the companies listed on the SEHK is the second largest in Asia and the sixth largest in the world, at more than US$2.8 trillion as of the end of 2012. It was also the most active market for initial public ofering funds raised globally in 2009, 2010 and 2011[27]. Hong Kong has also established itself as the premier stock market for Chinese firms seeking to list abroad. Over the past decade, As of December 2013, 1,643 companies were listed on the SEHK, with about 46.6% of the firms from mainland China, as well as overseas.

2.2.3 Legal and Regulatory Environment

The legal and regulatory framework of Hong Kong is largely influenced by the British practices. The principal statues regulating all Hong Kong companies are the Hong Kong Companies Ordinance, Securities (Disclosure of Interests) Ordinance, Securities (Insider Dealing) Ordinance and Takeover Codes. Non-statutory standards and rules include Main Board Listing Rules, Growth Enterprise Market (GEM) Listing Rules, Listing Agreements, and Code on Corporate Governance Practice laid down by the Stock Exchange of Hong; Statements of Standard Accounting Practice and Auditing Standards issued by the Hong Kong Society of Accountants

---

[24] Hong Kong Society of Accountants (HKSA). 1997, Second Report of the Corporate Governance Working Group (January)

[25] Jan Selmer and Corinna de Leon, 'Culture and management in Hong Kong SAR', in Malcolm Warner (ed) Culture and Management in Asia (2003) 48, 53

[26] South China Morning Post (SCMP). 2000. Family control and the Asian crisis. Business Post (September 20

[27] David Graham *Hong Kong Corporate Governance: A practical Guide* In Benita Yu and Laurence Rudge, Slaughter and May Ed.WhitePage Ltd London 2014

(HKSA); and Guidelines on Corporate Governance for SMEs in Hong Kong issued by the Hong Kong Institute of Directors.

Banks and other financial institutions are subject to further regulation by the governance and disclosure rules laid down by the Hong Kong Monetary Authority (HKMA).

Securities and Futures Commission (SFC)

The principal regulator of Hong Kong's securities and futures markets is the Securities and Futures Commission (SFC), an independent statutory body established in 1989 by the Securities and Futures Commission Ordinance (SFCO). The SFC is responsible for administering the laws on the securities and futures markets and facilitating and encouraging the development of these markets in Hong Kong. The Securities and Futures Commission (SFC) exercises supervision over the securities and futures. It monitors trading in the securities and futures markets to detect possible malpractices. It also conducts periodic inspection and makes inquiries in response to public complaints about malpractice in the stock market. The rules made by the Hong Kong Stock Exchange are subject to the approval of the Commission. SFC administers statutory requirements to ensure full disclosure and fair treatment of the investing public.

SFC is empowered to inspect a listed company's books and records in case of suspicion of impropriety in the management of a company's affairs. SFC also has frontline regulatory responsibility for takeovers and mergers, offers of investment products, and financial intermediaries other than SEHK and HKFE members.

Financial Reporting Council

The Financial Reporting Council (FRC) is an independent statutory body set up under the Financial Reporting Council Ordinance in 2007. The FRC plays an important role in the oversight of the auditing profession and issuers' financial reporting. In particular, its role is to:

- conduct independent investigations into possible auditing and reporting irregularities in relation to issuers and
- enquire into possible non-compliance with accounting requirements.

Companies Ordinance

Hong Kong's company law is essentially based on the UK Companies. All companies in Hong Kong are regulated by the Companies Ordinance. The Companies Ordinances of 1865, 1911 and 1932 followed parallel company law reforms in the UK Acts. On the lines of the UK company law, the Companies Ordinance in Hong Kong has important provisions regarding the establishment and conduct of affairs of companies, including issue of shares and bonds, auditing, annual meetings, and accountability of directors and other officers. The Ordinance requires

annual statutory reports for companies incorporated in Hong Kong, China and for overseas companies listed on SEHK which should include information such as the principal activities of the company, names of the directors, the amount which the directors recommend should be paid as a dividend, the amount of donations, directors' remuneration, etc. The auditor has been given a right of access to the books and accounts of the company and to require information and explanations from officers of the company for the performance of his duties. The Ordinance requires every company to keep proper books of accounts. The Ordinance contains several provisions which aim at ensuring that the rights of the shareholders of the company are adequately protected.

To modernise Hong Kong's corporate law and strengthen corporate governance, the new Companies Ordinance was passed in 2012 and which was implemented with effect from 3 March 2014. Some key measures for enhancing corporate governance under the new law includes clarifying and codifying directors' duty of care, skill and diligence, strengthening of auditors' rights and enhancing shareholders' involvement in the decision-making process.

The Securities (Disclosure of Interests) Ordinance administered by the Securities and Futures Commission (SFC) requires that the directors and the major shareholders of the company disclose their interests in the company shares to the other investors. The aim is to provide a fair, orderly, transparent, and efficient market for listed securities. Substantial shareholders are required to notify SEHK of any additional acquisition or disposal of relevant shares.

Hong Kong Society of Accountants (HKSA) is a statutory licensing body of professional accountants in Hong Kong responsible for the regulation of the accountancy profession. A company incorporated under the Companies Ordinance must appoint an auditor who must be a professional accountant holding a practicing certificate issued by HKSA.

The Listing Rules prescribe conditions and obligations relating to listing. Stock Exchange of Hong Kong (HKSE) Listing Rules stipulates in detail the requirements of sponsors, authorized representatives and directors. The HKSE is responsible for day-to-day supervision and regulation of listed companies, their directors and controlling shareholders. Though the SEHK does not have statutory power in disciplining listed companies, it relies on non-statutory rules such as the Listing Rules and the Takeovers Code.

2.2.4 Code on Corporate Governance Practices

The Stock Exchange of Hong Kong Ltd (SEHK) introduced its first Code of Best Practice in 1993 which was a non-mandatory guideline for companies to devise their own codes of practices. In 2005, following a lengthy consultation process, the SEHK adopted the Code on Corporate Governance Practices in place of the Code of Best Practice. This included a new set of Listing Rules requiring issuers to include a corporate governance report in their annual reports. The Corporate Governance Code is divided into principles, code provisions and recommended

best practices. This combination is designed to allow flexibility for issuers while protecting investors and the integrity of the market. Listed companies are required to confirm their compliance with the Code or, where they do not comply, to provide explanations for any variation in practice.

The Code has five parts: Board of Directors, Remuneration of Senior officers, Accountability and Audit, Delegation by the Board and Communication with Shareholders. The Code replaces the Code of Best Practice[28]. Hong Kong listed companies are required to comply with the Code unless they can provide a satisfactory explanation to the contrary. However, absence of the explanation does not lead to any penalties or sanctions.

Boards of Directors

Hong Kong's Corporate Governance Code requires every listed company to be headed by an effective board of directors, which should assume responsibility for its leadership and control. The board should regularly review the performance of each director, who should act in the best interest of the company.

The board, as per the Code should include a balanced composition of executive and non-executive directors, including independent non-executive directors, to enable the board to exercise independent judgment. The board of directors must include at least three independent non-executive directors (INEDs), representing at least one third of the board. At least one INED must have an accounting or a related financial management qualification and expertise .Directors should be provided with timely and appropriate information to enable them to make informed decisions. There should be a formal and transparent procedure for the appointment of directors, and all directors should be subject to re-election at regular intervals. From 1 September 2013, a new code provision was introduced in the Code that requires the nomination committee to have a policy concerning board diversity or otherwise explain why no such policy has been adopted. In addition, there is a new mandatory disclosure requirement for inclusion of such a policy, if one exists, in the corporate governance report.

The Code also requires a clear division of the responsibilities of the management of the board and the day-to-day management of the company's business. In this respect, the Code requires that the roles of chairman and chief executive officer should be separate and should not be performed by the same individual. Board meetings should be held at least four times a year.

The Code makes it clear that the board should be responsible for corporate governance. Training of directors was also introduced as a code provision. In relation to board committees, code

[28] Alex Lau and Angus Young 'Corporate Governance in Hong Kong: The State of Affairs' *Regulatory Compliance Journal*, Vol. 2, September 2006

provisions were introduced on the terms of reference of the audit, remuneration and nomination committees. The Code prescribes the provisions on the establishment and composition of a nomination committee.

Audit Committees

Hong Kong listed companies must establish an audit committee. The Code has laid down details of the functions of the audit committee. The Listing Rules also specify the composition of audit committee. The committee must by wholly comprised of NEDs and it must have at least three members. At least one of the members must be an independent NED with sufficient and appropriate financial experience.

Risk Management

In Hong Kong, boards rely on audit committees to provide oversight of risk management, internal audit functions and the work of the external auditor. While the board provides oversight of the process, the process of risk management itself involves understanding of objectives of the company; identifying risks associated with achieving the objective or not achieving them; developing programmes to address the identified risks; and monitoring and evaluating the risks and the arrangements in place to address them. Risk management is essential for reducing the probability that corporate objectives will be jeopardized by unforeseen events. The board must determine the type and extent of risks that are acceptable to the company, and strive to maintain risk within these levels.

Remuneration

Hong Kong listed companies should disclose its directors' remuneration policy and other remuneration related matters. A formal and transparent procedure for setting policy on executive directors' remuneration and for fixing the remuneration packages for all directors should be in place. The Code also requires that a remuneration committee with specific written terms of reference should be established. No director should be involved in deciding his or her own remuneration.

2.2.5 Challenges of Corporate Governance in Hong Kong

Despite a common law colonial legacy, a strong judiciary, good ethical standards, low corruption, evolution of Hong Kong as a hub of banking and financial institutions, and high priority to improve corporate governance accorded by the Hong Kong Government and the regulators, Hong Kong has certain corporate governance weaknesses which pose a challenge to the regulators.

Regulation of Non- Hong Kong Based Companies

A unique regulatory problem of Hong Kong is that more than 75 per cent of companies listed on the Stock Exchange of Hong Kong are 'non-Hong Kong companies', not formed and registered under the Companies Ordinance of Hong Kong. Consequently, they are not subject to the provisions of the Hong Kong company law but by the corporate laws of their home countries[29]. This imparity leads to different level of protection to the individual shareholders.

Weak Regulatory Framework

The regulatory framework of Hong Kong is three-tier: the government, the Securities and Futures Commission (SFC) and the stock exchange. While the Hong Kong government is the overall regulator, the domain of SFC extends only to listed companies and Hong Kong Stock Exchange enforces the Listing Rules. The SFC relies on disclosure-based regulations. The Code of Corporate Governance issued by Hong Kong Stock Exchange operates on 'comply or explain' principle. There is no penalty for non-compliance. The Hong Kong Stock Exchange lacks teeth and expertise to ensure listing compliance[30]. The overlap, conflict and gray areas are the contending issues among the three regulators leading to unintended weak regulations.

Lack of Sound Corporate Governance in SMEs

Many of the developments in international corporate governance have been made in connection with listed public companies. Only a small proportion of SMEs in Hong Kong fall into this category. The principles and provisions recommended for listed companies have little or no relevance to many SMEs in Hong Kong which numbered about 260,000 as at September 2008, about 98% of the total business establishments[31]. These SMEs face new challenges to attract equity and debt finance in a fast changing market conditions and globalisation. Lack of sound corporate governance is an impeding factor. The Hong Kong Institute of Directors has issued guidelines for the SMEs but these have not been adopted being voluntary.

Family Owned and Controlled Companies

One of the features of listed companies in Hong Kong is the number of family-owned or parent-controlled companies. As per the 'Asian Family Businesses Report' issued by Credit Suisse in 2011, 62% of listed companies in Hong Kong are owned and controlled by families. Although the controlling families can reduce some agency costs compared to companies with dispersed ownership, and the principal-owner conflict does not arise. But it may give rise to what is known as 'private benefits of control' which may put non-controlling shareholders at a disadvantage. Family shareholders tend to dominate the boards of directors and have fewer independent

---

[29]S.S.M. Ho 'Hong Kong System of Corporate Governance' In A.Naciri Ed *Corporate Governance Around the World* Routledge 2008.
[30]op. cit.
[31] Guidelines on Corporate Governance for SMEs in Hong Kong (2nd edition) The Hong Kong Institute of Directors

members so that the board tends to become a fiction or a ‘cozy club’ as the nomination and election of board members tend to revolve around personal relationships and acquaintances. Given the predominance of controlling shareholders and concentrated ownership, minority shareholders often feel powerless to influence the outcome of board elections (OECD, 2012). This gives rise to potential conflicts between the management and the minority shareholders.

In general, the public listed companies in Hong Kong are owned and managed through blood and marriage ties[32]. More often, the family members and their relatives act as the senior executives and board members turning the three facades of corporate entity as owner-director-managers into one. This gives rise to high incentives for families to extract benefits for the families at the cost of the minority shareholders. Domination of one individual or family in companies hampers the growth of the stock market as well on account of low free float of shares.

Connected Transactions

In the early 1980s, banks in Hong Kong which were then mostly owned by families, encountered difficulties on account of reckless lending to connected parties. To deal with such abuses, the power to regulate bank ownership structure was strengthened and restrictions on connected lending were implemented by Hong Kong Monetary Authority (HKMA) which was empowered by enacting Banking Ordinance. Since then, various legislative provisions and policy guidelines have been continuously updated by HKMA to achieve internationally accepted standards. Currently, most banks belong to financial groups, and the approval of HKMA is required in order to acquire 10 percent or more shares. With these efforts, the banking sector has played an important role in corporate governance.

In Hong Kong, there are a high number of connected transactions because issuers are predominantly controlled by a dominant shareholder (eg an individual or a family). Given the nature and number of closely held companies in Hong Kong, a robust framework for connected transactions is a critical component of the corporate governance framework. The Stock Exchange in Hong Kong requires approval of the shareholders with regard to connected transactions and disclosure of connected transactions. The exchange also tracks companies and directors who fail to notify shareholders about connected transactions. To what honesty the related transactions are disclosed to the shareholders is a question mark on account of weak regulations by the regulators.

Lack of Independence of the Board

As per the Corporate Governance Review by BDO Corporate Governance Academy in 2014, many companies continued to lack of separation of the roles of chairman and chief executive.

[32]S.S.M. Ho ‘Hong Kong System of Corporate Governance’ In A Naciri Ed *Corporate Governance Around the World* Routledge 2008.

This makes it difficult to believe that the spirit of independence prevails in such companies. Hong Kong companies are still not prepared to embrace the significant role and responsibilities of a nomination committee, as few companies believe that the board is the most suitable body to assess the most desirable skills and competencies for director selection and appointment. With the board itself retaining the ultimate responsibility for these practices, it is difficult for it to demonstrate that the processes involved in the selection and dismissal of executives and non-executive directors, as well as the evaluation of board performance and succession plans, are carried out in a thorough, fair, independent and transparent manner.

Directors' Pay

As in many Asian countries, the board of directors in Hong Kong generally determines its own remuneration. Without effective monitoring mechanisms, company directors may decide on excessive compensation that is totally unrelated to performance. The rapid increase in directors' pay during the 1990s, associated particularly with stock options, has heightened the need for disclosure of directors' emoluments. To improve accountability and transparency in directors' remuneration, SEHK, since 1990, has urged listed companies to disclose their directors' remuneration on a voluntary basis.

References

A.C. Fernando (2006), *Corporate Governance, Principles, Policies and Practices*. Pearson.

Alex Lau and Angus Young (2006) 'Corporate Governance in Hong Kong: The State of Affairs' *Regulatory Compliance Journal*, Vol. 2, September

Chow P, (2006). 'Implementing Corporate Governance Reforms in Hong Kong' *Exchange*

Clarke T and Clegg S, (2000) *Changing Paradigms: The Transformation of Management Knowledge for the 21st Century*, London, Harper Collins Pub. Clarke T, 'Introduction' in Thomas Clarke (ed), *Theories of Corporate Governance, The Philosophical Foundations of Corporate Governance*, London, Routledge

David Graham (2014) *Hong Kong Corporate Governance: A Practical Guide* In Benita Yu and Laurence Rudge, Slaughter and May Ed.WhitePage Ltd London

F. Mayer (1997), Corporate Governance, Competition, and Performance', In *Enterprise and Community: New Directions in Corporate Governance*, S. Deakin and A. Hughes (Eds), Blackwell, Oxford.

Guidelines on Corporate Governance for SMEs in Hong Kong (2nd Edi) The Hong Kong Institute of Directors

Hong Kong Society of Accountants (HKSA). 1997, Second Report of the Corporate Governance Working Group (January)

Jan Selmer and Corinna de Leon (2003) 'Culture and Management in Hong Kong SAR', in Malcolm Warner (ed), Culture and Management in Asia 48, 49-53

Joongi Kim, 'A Forensic Study of Daewoo's Corporate Governance: Does Responsibility Lie Beyond the Chaebol and Korea?' (HGCY Working Paper Series, Hills Governance Centre

K. Keasey, S. Thompson and M. Wright (1997), _Introduction: Thecorporate governance problem - competing diagnoses and solutions,'InK. Keasey, S. Thompson and M. Wright, *Corporate Governance: Economic, Management, and Financial Issues*. Oxford University Press:Oxford.

Liang, N. and Useem, M. (2009). Corporate Governance in China, in *Handbook of International Corporate Governance, Institute of Directors*, United Kingdom, pp.167-175.

Lu, J. H. (2003). Corporate Governance in China, A Report for the Center for Corporate Governance, Institute of World Economics and Politics.

McKinsey Quarterly (2004). *Asia's Governance Challenge*.

Mick Carney and Howard Davis (2000), 'From Entrepot to Entrepot via Merchant Manufacturing: Adaptive Mechanisms, Organizational Capabilities and the Structure of the Hong Kong Economy', in Chris Rowley and Robert Fitzgerald (ed) *Managed in Hong Kong: Adaptive Systems, Entrepreneurship and Human Resources* 13, 17-29

Neng Liang and Michael Useem 'Corporate Governance in China' (www.ceibs.edu)

O.E.C.D. (1999) Principles of Corporate Governance: A report by OECD Task Force on Corporate Governance.

Rajagopalan, N. and Zhang, Y. (2008). "Corporate governance reforms in China and India: Challenges and Opportunities." Business Horizons 55

S.S. M. Ho (2008) 'The Chinese National System of Corporate Governance' In *Corporate Governance Around the World* by A Nachiri Ed. Routledge

Schipani, C. A. and Liu, J. H. (2002), "Corporate governance in China: Then and now." Columbia Business Law Review,

South China Morning Post (SCMP). 2000. Family control and the Asian crisis. Business Post, September 20

Symposium Report, December 1998). Boyce G and Ville S, *The Development of Modern Business* UK, Palgrave (2002)

Thomas W. Lin (2004), 'Corporate Governance in China: Recent Developments, Key Problems and Solutions' *Journal of Accounting and Corporate Governance,* Vol. 1 June

Useem, Mike and Neng Liang (2012). Globalizing the Company Board: Lessons from China's Lenovo, *Corporate Governance Asia*, May, pp. 4-9.

www.protivity.com

3

JAPAN

3.1 Country Analysis

Japan developed into a technologically advanced economy in the years following World War II, prompted by government-industry cooperation, a strong work ethic, mastery of high technology, and a comparatively small defense allocation. The notable characteristics of the post-war economy of Japan were the close interlocking structures of manufacturers, suppliers, and distributors, known as keiretsu, and the guarantee of lifetime employment for a substantial portion of the urban labor force[33].

Growth slowed down in Japan in the 1990s largely because of the excess debt, capital, inefficient investment and an asset price bubble in the late 1980s. A sharp downturn in business investment and demand for Japan's exports in late 2008 pushed Japan into recession. Economic revitalization programme of the Japanese Government aimed at opening up of the economy to increased foreign competition and create new export opportunities for Japanese businesses helped the economy recover since 2010[34].

Currently, Japan has the world's largest electronics goods industry and is the third largest automobile manufacturing country, Toyoto being the world's largest car maker[35]. Measured on purchasing power parity (PPP) basis that adjusts for price differences, Japan stood as the fourth-largest economy in the world in 2013. Huge government debts, social welfare spending, reliance on exports to drive growth and an aging, shrinking population are the major long-term challenges for the Japanese economy.

3.2 Corporate Governance in Japan

Japan has developed a unique corporate governance structure while re-building its economy post World War II. The striking features of which are:

- Powerful government intervention dominated by the Japanese Ministry of Finance (MOF) to keep strong regulatory control
- Cross- shareholding by affiliated companies which spreads corporate growth throughout the group.

---

[33] World Fact Book, CIA (https://www.cia.gov/library/publications/the-world-factbook/geos/ja.html)

[34] Op.cit

[35] 2013 Production Statistics – First 6 Months. *OICA*.Retrieved16 October 2013.

- Close relationships between the government and the corporate sector
- Focus of corporate priorities on growth and market share instead of profit and shareholders' returns, except through capital appreciation
- Corporate governance based on Japanese culture of three interlinked concepts of " obligation", "family" and " consensus"

Although Japan has adopted the legal institutions of the USA, corporate governance in Japan is governed more by non-legal norms which are rooted in the Japanese culture. The important features of corporate governance in Japan include:

- Dominance of Large Business Groups (*Keiretsu*)
- Main Bank System
- Long-term Relationship

Dominance of Large Business Groups (*Keiretsu*)

Japan's corporate governance system is characterised by dominance of large business groups known as a *Keiretsu*. *Keiretsu* is a Japanese word which means headless combine. It is a form of group structure in which a number of organisations are linked together, usually by cross shareholding or mutual shareholding. In this net-work of companies, each of the company holds shares in the other companies in the group.

The early corporate formations in Japan were termed as *Zaibatsu* which means monopoly. *Zaibatsu* began as small, family-owned enterprises that were formed across Japan to specialise in the separate businesses to meet the needs of the nation at that time. *Zaibatsu*, the first of which was Mitsui established in 1876, (other prominent *zaibatsu* were: Mitsubishi, Sumitomo and Yasuda) was a totally integrated group engaged in manufacturing, distribution, trade and finance across a wide range of businesses. These prospered with a lot of subsidies and contracts from the Meiji Government.

The individual *zaibatsu* had a monopoly in one or two industries. By the end of the First World War, each *zaibatsu* had launched at least one major manufacturing company in each sector and controlled, respectively, a bank, an insurance company, a shipping line and trading company. In 1930, approximately 75% of Japan's Gross Domestic Product was directly or indirectly controlled by the largest *zaibatsu*[36].

After Japan's collapse in the Second World War, the American forces coerced the *zaibatsu* to be dissolved into many smaller companies with a view to destroy the economic base of the Japanese military and prevent monopolistic concentrations. The process of the dissolution of

[36] Kensy, 2001

the *zaibatsu* was stopped in 1948 with the changes in the global political situation. Many of the Zaibatsu were re-established which were called *Keiretsu*. Some emerged out of former *zaibatsu* and most others were new groupings of companies.

Keiretsu is "the close, long- term business relationships established by large corporations with select groups of smaller firms, and they are linked through investment and the exchange of personnel". The fundamental principle of a *keiretsu* is long-term agreements between companies in the group. *Keiretsu* organises the operational activities of group companies which cover marketing, logistics and distributions, transport, warehousing, insurance and other ancillary administrative services. Besides providing access to funds *Keiretsu* also provides quick access to updated information to the member companies. Some of the biggest *keiretsu* in Japan are: Mitsubishi, Sumitomo, Mitsui, Fuyo, Sanwa, and Daiichi-Kangin.

There are broadly two types of *keiretsu*- horizontal and vertical. A horizontal *keiretsu* is a group of large companies which are independent and operate in different industries. The *Mitsubishi* Group is one such example. These are linked by cross-shareholding, intra-group financing and interlocking directorates. These are governed by a central body of directors called president club, which is not the formal arrangement. The group is further cemented by a bank and a centralised trading company.

A vertical *keiretsu* is a group of hundreds or thousands of multi-layered small companies of suppliers around one large manufacturing company (usually assembler). The shape of the vertical *keiretsu* is a pyramid. The vertical *keiretsu* are usually prevalent in automotive and electronic industry in Japan, for example, *Toyota*. Many suppliers also depend on the assembler for capital, technology, management know-how and manpower. Unlike horizontal *keiretsu*, power relations are not equal in vertical *keiretsu*. The assembler has much more power than its suppliers. The assembler has the option of terminating relations, while its suppliers can leave the *keiretsu* and join new *keiretsu*.

The financial crisis of 1997 put pressure on the Japanese Government to initiate wide-ranging reforms. As part of the reforms the Financial System Reform Law was enacted which legalise formation of financial holding company under which subsidiaries were allowed to be formed. The government also introduced a number of new corporate accounting reforms which make it difficult for parent companies to conceal profits or losses of non-viable subsidiaries. The government also liberalized the foreign exchange operations: capital transactions, foreign direct investment, and the Tokyo offshore market.

The reform process has the impact on the *keiretsu* structure especially the relationship between a bank and *keiretsu* companies. Many *keiretsu* companies, especially automotive and electronic

companies were forced to implement the reforms to meet the foreign competition emanated out of opening up of the Japanese economy.

Main Bank System

The main source of funds of Japanese companies is mostly banks and other financial institutions which provide debts as well as equity capital by a consortium led by a major bank called 'main bank'. The banks are linked through Keiretsu as most banks are affiliates of Keiretsu. Banks hold considerable amount of shares in the companies on a long term basis and build strong relationship with the client firms. The bank executives are also offered board membership. Thus, the corporate governance system in Japan is a bank model based on support of the banks.

Main bank system established in 1944 to streamline the supply of funds for weaponry production was one of the central features of the post- war financial system of Japan. During the post war period, firms were heavily dependent on bank loans to fund their rapid growth. The main bank coordinated a firm's financing activities and watched it carefully to ensure that it had the managerial capability to grow, continue to procure financial services and to pay back its loans. Main banks led restructuring activities when a firm faced financial crisis and were known to intervene when they believe that the senior management was not competent enough[37].

After World War II the main bank system continued to provide funds to the companies with the support of Ministry of Finance. The ministry complemented the system by the policies of protective supervision, low interest rate, and restraining the development of the bond market. This system made possible long-term, large-scale investments by companies.

Under the system, banks themselves have a social relationship with the company they lend to, especially if they are the main bank for that given company. In order to avoid hostile takeovers, the banks buy the shares of these companies and those companies also buy the shares of the bank. This cross-holding of shares plays an important role in active equity financing. It is also useful to strengthen their position when a company faces any serious problems. At present, the banks can invest in the stock of a company only up to 5%. Japanese banks are the largest owners of equity shares in comparison with other countries. The banks often nominate a senior banker in the board of a client company as their representative.

The role of the Japanese banks in corporate governance depends on the strength of the customer. The influence of the banks is minimal when the company is an established one while a company in trouble may find it losing its freedom to the bank. They may assume great role in times of trouble for a company.

[37]Christina L. Ahmadjian and Ariyoshi Okumura 'Corporate Governance in Japan' In *Handbook on International Corporate Governance: Country Analysis (2nd Edition)* Ed Christine A. Malin, Edward Elgar, 2011

The main bank system started to weaken in the 1980's with globalisation setting afoot. The largest and most solvent companies began to move away from the main bank system and shifted to direct financing through capital markets. The Ministry of Finance also eased its supervision over the banks.

While the bank-based system received a wide acclaim in 1980s for its contribution to the success of the Japanese economy, it came to be regarded as the contributor to the country's recession in 1990s. This is because with the stagnation of the economy, non-performing loans increased manifold. Eventually, a full-scale crisis in the Japanese banking sector broke out with the bankruptcy of Sanyo Securities and Hokkaido Takushoku Bank in 1997.

Reforms- Big Bang

The long-term economic recession in the 1990s, and the growing crisis in the banking sector triggered the reform process in Japan which is known as the 'Big Bang'. Big bang refers to a radical change in a banking and financial system, which accelerates market-led financial sector reform. Its objective is liberalisation of the financial sector and opening of financial market.

The Japanese Government announced the big bang plans in late 1996 and completed it by 2001. The main objectives were to enhance competitiveness of the Japanese financial markets and to provide more opportunities to the financial institutions to compete freely for business.

The big bang in the Japanese financial sector weakened the main bank system considerably. The role of the main bank as a designated monitor was reduced as banks and other financial institutions monitored the companies they dealt with on their own. With the increase in direct financing activities of companies, banks sold the shares of profitable companies in the market.

Long-term Relationship

Most of business groups in Japan i.e. *Keiretsu* (such as Mitsubishi, Mitsui, Sumitomo) are linked by cross-shareholdings and relationships with number of small businesses. *Keiretsu* is based on stable long-term relationship. These groups and government relations have traditionally been close. These relations are reinforced within the groups often employing retired civil servants and work together on government sponsored committees also. These relations are often encouraged by the government to promote new technologies and standards to increase competitiveness. Retired government officers placed on the boards of the companies seek preferential treatment from the government. The retired bureaucrats also ensure effective implementation of the government policies.

Long-term employment is a typical feature of the Japanese model. An employee who is recruited is expected to remain in the company for the length of his or her career. In return, he or she can expect not to be fired or discharged, except under some extraordinary circumstances. Employees

are generally identified with the companies in which they work. This gives a sense of belonging and loyalty to the company.

Japanese corporate culture is often described as a family system, basedon obedience, hierarchy and loyalty. If one company has difficulties, it is likely to be assisted by other companies from the same keiretsu. More powerful companies are expected to support smaller ones. Thus, the sense of obligation towards the company may be linked with the sense of belonging to a family.

Structure and Role of Board of Directors

The structure of the board of directors in major listed companies known as *kabushikikaisha* is the traditional unitary board where important decisions, broad policies and strategies are decided by the board. On the face of it, the structure resembles the U.S. companies. But in practice, the boards of Japan's major corporations represent the interest of the company as an integrated social unit, not the interest of shareholders. Unlike the Anglo- Saxon model based on primacy of the shareholders, the Japanese model seeks to balance all stakeholders such as creditors, employees, managers and government.

The board of directors of Japanese company is marked by a very large size, for example in July 2002, Toyota had 58 board members; Sony in 1997 had 38 board members. One reason for that is board membership in Japanese firms is frequently offered as a reward to long-serving, committed employees. Nearly 90 percent of the directors are senior managers or former company employees. This ensures participation of employees in the governance of the companies and extracts long term commitment to the firm. Other members of the board are executives from banks, customers, suppliers, parent company and retired government officials all included in the board to solidify good long relationships.

Theoretically, board of directors has the ultimate authority to oversee the functioning of the company on behalf of the shareholders, in practice, however, the boards have surrendered traditionally most of their authority to the company President. The main authority lies with the president who chooses the board of directors in consultation with other senior members and the chairman. These directors are first nominated and then put to election and selection in the annual general meetings before the shareholders. The president and the top management compare the goals set by the company and evaluate the company's performance against the same. The boards are rather a decision- ratifying body than being a decision taking body. In some cases, the meetings of the board tend to be only ceremonial.

Corporate decisions are made through various forms of meetings and communications which is based on personal relations rather than on formal ways of communication. The President maintains a web of personal relationship with business associates and government officials. "*Shacho-kai*" (Presidents Club), which is an informal organ meets regularly and makes strategic decisions. The Japanese model of governance is thus, described as 'network model'[38].

3.3 Corporate Governance Laws in Japan

Japanese corporate law has been modeled with that of Western countries. Japan's first declaration of a corporate code came in 1899, after the Japanese government commissioned a German scholar named Hermann Roesler to write a draft based on the German code.

The corporate code went through several revisions during the first half of the 20th century, but was largely discarded after World War II, in part because the U.S. Occupation forces believed that the nature of Japanese corporations was one of the factors that led to Japanese aggression preceding the war. In its place, Occupation officials encouraged Japan to adopt a more democratic corporate governance structure.

The primary architects of the new code called 'Commercial Code' were officials in the Legal Section of Supreme Commander for the Allied Powers' (SCAP). As a result, the Japanese Commercial Code closely resembles the Illinois code. Although SCAP sought the input of Japanese officials, scholars, and business organizations in framing the Commercial Code, the final draft of the code adopted by the Diet in 1950 was a copy of the Illinois code.

Since the war, the Commercial Code has been revised 22 times, some of which have been substantial reforms. The most thorough reforms were introduced in the year 2002 which mark a shift away from the five main characteristics of the traditional Japanese corporate environment:

- (i) Bank-centered capital markets
- (ii) Keiretsu-controlled stock ownership patterns
- (iii) Administrative guidance
- (iv) Insider dominated board of directors
- (v) Weak external monitoring of corporate management.

The collapse of the bubble economy and intensifying globalisation forced Japanese corporate governance to adapt to a more shareholder-centered system of corporate governance to raise funds in the international market and remain competitive.

[38] Moerland,1995

The revised Commercial Code which came into effect on April 1, 2003 brings the Japanese system of corporate governance closer to the US model. The revised Code defines for the first time in the history of corporate Japan differentiation between directors who were charged with oversight responsibility over the officers and basic decision-making, and officers responsible for day-to-day managerial functions.

The Code introduced an innovative corporate structure- Company with Committees. Patterned on the US system, it was made optional for the companies to adopt. For the companies opting for this structure it is made mandatory to establish three board committees- audit committee, compensation committee, and nomination committee. The Code also stipulated presence of majority of outside directors in each of these committees.

Until 2005, the legal provisions relating to the company system in Japan were scattered over the Commercial Code and numerous other pieces of legislation. The company law used to be the part of the Commercial Code. In 2005, the Japanese Government adopted a new Companies Act. The Companies Act 2005 brought almost all relevant legal provisions concerning functioning and governance of companies in one law. The Companies Act 2005 which came into effect on May 1, 2006 is not just a change of format or nomenclature but it has brought significant changes in the law to be in line with international standards.

The new Act updated the regulations, gave an option as to the types of companies that could be established, abolished the minimum capital requirements and reformed the internal structure of companies.

Another change in the regulatory environment was the introduction of the Japanese version of Sarbanes Oxley called J-SOX. This became effective in 2008 and increased the requirement for internal control, requiring companies to submit a report on their internal control system, which is required to be approved by a public auditing firm.

3.4 Corporate Governance Structures in Japan

The company law in Japan provides two kinds of corporate governance structures:

- Company with Corporate Auditors
- Company with Committees

Companies have been given a choice to adopt a board of company auditors or a board with committees.

Company with Corporate Auditors

The company auditor system has been in existence in Japan for over a century from the time of enactment of the old Commercial Code. It is a unique system specific to Japan which exists neither in the Anglo-Saxon countries nor in Germany.

A majority of Japanese listed companies employs the board of corporate auditors system. Under this system, the board of corporate auditors is a legally separate and independent body from the board of directors.

In large public companies that have a board of company auditors, there must be at least three auditors, a majority of whom are outside company auditors. An outside corporate auditor is defined as a corporate auditor who has not served as a director, accounting councilor, executive officer, manager, or any other employee of the company or any of its subsidiaries.

Company auditors are different from accounting auditors as no specific qualifications are prescribed for them. They are elected by shareholders of the company in the general meeting. They represent the interest of the shareholders by monitoring the execution of duties by directors and ensuring that board’s decisions comply with the laws.

The main function of the board of corporate auditors is similar to that of independent directors, including those who are members of the audit committee, of a U.S. company. It also review and express an opinion on the method of auditing by the company's accounting audit firm and on such accounting audit firm's audit reports, for the protection of the company's shareholders. The rules provide that a large company must have three or more corporate auditors who comprise the board of corporate auditors. Their role is to audit both accounting and directors’ execution of work. In a small company, the role of a corporate auditor is only to audit the accounting procedures. In a medium sized company, their role is to audit both accounting and directors’ execution.

A corporate auditor has a four-year term. A company auditor may not act concurrently as a director or employee of the company or its subsidiary. Company auditors prepare an audit report once a year. Company auditors attend board of directors meetings and are required to state their opinions if necessary. Company auditors may, at any time, request reports on the business from directors and others, or investigate the status of the company's operations and finances.

For Japanese companies that employ a corporate governance system based on a board of corporate auditors, there is no independence requirement with respect to directors. A company with corporate auditor must have at least one representative director who is appointed by the board of directors. The representative director legally represents the company and may optionally appoint executive directors. The representative director and executive directors execute the affairs of the company under the supervision of the board of directors.

Honda is an example of a company with corporate auditors. Currently Honda has five corporate auditors and the term of each corporate auditor at Honda is one year. Honda's directors and corporate auditors are elected at the meeting of the shareholders. The maximum amounts of compensation also are decided at the meeting of the shareholders.

Company with Committees

Company with Committees system was introduced into Japanese company law in 2002. The introduction of this system was aimed at increasing the international competitiveness of Japanese companies and providing companies with an option of a corporate structure option to bring corporate governance at par with the international norms. This system works alongside the Company with a Corporate Auditor system, and Large Companies and Constructive Large Companies may choose either system. This structure is adopted by a very few companies in Japan- by 2009 only 2.3% of companies listed on the Tokyo Exchange had adopted this system.

In a Company with Committees, execution and supervision are more clearly separated than in a Company with a Corporate Auditor. Companies with Committees cannot have any corporate auditors. Instead, the Company with Committees is required to have three committees:

- Nominating Committee
- Audit Committee
- Compensation Committee

The authority of each committee is prescribed. The members of each committee are appointed by the board of directors. Each committee must consist of three or more directors, and a majority of the members of each committee must be "outside directors" who are not executive officers of the company. Japanese law stipulates that outside director "means a director of any stock company who is neither an executive director nor an executive officer, nor an employee, including a manager, of such stock company or any of its subsidiaries, and who has neither ever served in the past as an executive director nor executive officer, nor as an employee, including a manager, of such stock company or any of its subsidiaries." The members of an audit committee may not serve concurrently in roles such as that of executive officer of the company or its subsidiaries.

Functions of Committees

The revised Code prescribes functions of each of the board committees.

Audit Committee

(i) To oversee directors and executive officers;
(ii) To approve financial statements;

(iii) To recommend to the general meeting of shareholders Chartered Public Accountant (CPA) for appointment as auditor;
(iv) To represent the company in derivative action suits against directors and officers.

Nominating Committee
(i) To propose candidates for appointment as directors to the general meeting of shareholders;
(ii) To evaluate directors and CEO for re-election or removal.

Compensation Committee
(i) To determine all elements of compensations directors and officers;
(ii) To propose stock option plans to the general meeting of shareholders.

The role of the board of directors is to supervise executive officers, and make decisions on broad area of management. The status of directors as directors disqualifies them from executing the operations of a company with committees, however executive officers may act concurrently as directors.

The affairs of the company are executed by the executive officers who are appointed by the board of directors. The company is legally represented by a representative executive officer. The executive officers decide almost all matters of management. Therefore, decision-making is faster in a Company with Committees than in a Company with a Corporate Auditor.

The two corporate governance structures mentioned above are suitable mainly for large publicly-held companies. For small closely-held companies, the Limited Liability Company Law, enacted in 1938, provides a form of corporation with a simple corporate structure. In practice, however, a number of small-sized companies take the form of a stock company. Consequently, the majority of stock companies are closely-held companies, and the regulations as for the large-sized companies also apply to these small-sized companies.

According to a survey conducted by the Japan Corporate Auditors Incorporation there were 105 companies with committees in Japan as at 21 December 2006, and of that number 68 were listed companies and 37 were private companies. Some of the companies which adopted the new (innovative) system of company with committees include: Toshiba, Orix, Nomura Holdings and Konica-Minolta. This number is by no means large when viewed against the roughly 4,000 listed companies in Japan. On the other hand, there were 9 companies that had at one point switched to being a company with committees, but had then returned to being a company with a board of company auditors.

General Meeting of Shareholders

The company law in Japan requires all companies to have at least a shareholders' meeting. The shareholders' meeting appoints the directors. The corporate auditor, in case of traditional structure of company is appointed by the shareholders' meeting. Shareholders have also been given power to approve the accounts and proposal of payment of dividend. The general meetings are required to be held within 60 days after the end of the fiscal year. Shareholders are permitted to exercise their voting rights through electronics means.

However, the dampening factor of corporate governance in Japan is that general meetings are not effective as generally the duration of the meetings is kept very short in most cases for even less than half an hour. This is because majority of shares are held by institutional shareholders and affiliates of *Keiretsu* which are generally long-term. Most of the decisions generally are made by the major shareholders groups before the general meetings.

Problem of *Sokaiya*

One unique problem in Japan connected with shareholders' meetings is *sokaiya* or racketeers which have ties with criminal elements. Companies in Japan used these in 1970s to check shareholders activism and finish general meetings as quick as possible. They were paid for protecting against onslaught by shareholders. Although, payment to *sokaiya*has been made illegal in 1982, there are instances of such payments across companies. Many executives and officers of the companies involved in such payments have been fined and jailed.

Soon after *sokiayas*themselves became shareholders in the companies they were paid for protecting against unruly shareholders. With that it has even become more challenging to hold general meetings of the companies in Japan. Many listed companies in Japan hold their general meetings on the same day, typically on a day in the last week of June to ward off *sokaiyas.*

3.5 The Regulatory Framework

Financial Services Agency (FSA)

FSA is the most important agency in Japan to regulate and supervise securities market and financial institutions including banks and insurance companies. It has the authority to enforce Securities Exchange Law and Banking Law; to make rules for transactions in securities markets; establishes accounting standards; supervises CPAs; and to ensure compliance with the rules of the securities markets.

Securities and Exchange Surveillance Commission (SESC)

SESC is the market regulator in Japan established as an organ of the FSA. It is responsible for ensuring compliance with the rules of securities markets.

3.6 Corporate Governance Codes and Guidelines

Tokyo Stock Exchange Principles

Tokyo Stock Exchange set up in 2002, the Listed Company Corporate Governance Committee. In March 2004, the Committee published the "Principles of Corporate Governance for Listed Companies". These principles were revised in December, 2009.

The principles set forth in the document are not a requirement for listed companies to adopt, or a criterion of the best or minimum standard of model policies for corporate governance. These provide a basis for listed companies to enhance governance and a “common base for recognition” of corporate governance. These are:

1. Rights of Shareholders

Corporate governance for listed companies should protect the rights of shareholders. This should include the right to participate and vote in general meetings of shareholders on basic decisions of the company, including elections and dismissals of directors and auditors, fundamental corporate changes, the basic right to share various profits such as dividends, and the special right to make derivative lawsuits and injunction of activities in contravention of laws, regulations and other rules.

2. Equal Treatment of Shareholders

Corporate governance for listed companies should ensure the equal treatment of all shareholders, including minority and foreign shareholders.

3. Relationship with Stakeholders in Corporate Governance

Corporate governance for listed companies should help create corporate value and jobs through the establishment of smooth relationships between the company and its stakeholders and encourage further sound management of the enterprise.

4. Disclosure and Transparency

Corporate governance for listed companies should ensure that timely and accurate disclosure is conducted on all material matters including the financial condition, performance results and ownership distribution.

5. Responsibilities of Board of Directors, Auditors, Board of Company Auditors, and other relevant group(s)

Corporate governance for listed companies should enhance the supervision of management by the Board of Directors, Auditors, Board of Company Auditors, and other relevant group(s), and ensure their accountability to shareholders.

3.7 Challenges of Corporate Governance in Japan

Japan's corporate governance model serves well till 1990s and had been well acclaimed. But it was viewed as largely responsible for the Asian crisis of 1997. Some of the problems areas in Japanese system of corporate governance are as under:

1. Japan's distinctive corporate governance feature of combination of executive and board functions is one of the important problem areas in Japan which has been responsible for inability to effectively oversee executives. The Commercial Code requires Japanese boards to appoint from its members at least one "representing director" to act on the behalf of the corporation and to represent it in external matters. In reality, the representative director typically directs the internal operational policies of the corporation, appoints and removes the other directors, and sits as the chairman of the board. As the representative director is generally considered the highest position in the corporation, virtually no one can challenge his authority. Consequently, the representative director, not the board as a whole, determines the corporation's day-to-day business, serves as its key management figure, and is functionally accountable to no one.

2. The unique statutory auditor system of Japan also fails to serve as an effective mechanism to prevent executive abuse or safeguard shareholder interests. The Commercial Code requires Japanese corporations to employ one or more statutory auditors to "audit the execution by the directors of their functions. Under the statutory audit system the power of auditors have been defined narrowly to cover only legal compliance and accounting functions. They do not have a vote on the board nor are they charged with the responsibility of monitoring the overall performance of management. Moreover, auditors tend to be retired employees or employees of affiliated firms who are given the title as a token of appreciation. This has weakened the supervisory organ of corporate governance in Japan.

3. The composition of the board of directors also causes a lot of difficulty for the corporate governance structure of a company. Since the majority of people are company insiders who have been promoted to the post of directors as a reward for their lifelong service to the organization, it is undeniable that their priorities would lie with the organisation first and the other stakeholders, especially the shareholders only later. Since there are hardly any outside directors to objectively view the working of the company and give an

unbiased opinion on its functioning, this paves the way for many a scams and scandals to flourish. This was evident in the Toyota recall fiasco in 2010. Not one of the 29 board members of Toyota was in complete independence from the company.

4. Consensus-based decision making, part of the Japanese way of corporate governance is another problem area in today's fast changing complex environment of the business. This was clearly visible in the Toyota recall fiasco in 2010. The response time taken by Toyota to react was widely accepted to have been really slow. This was a result of Japanese system of consensus- based decision making and thorough investigations on their part to determine that there was a defect which led to a very long response time giving the time and space to media. Toyota is an example of Japanese corporate governance where slow and thorough analysis takes place, consensus is achieved and then results are made public.

5. Another distinctive feature of Japanese system is *keiretsu which* are characterised by "stable cross-share ownership, interlocking directorates, extensive product market exchanges, and other linkages that enhance group identity and facilitate information exchange." Frequently, these groups are centered around a main bank which holds shares of member companies and provides capital and other types of assistance. Companies maintain their cross shareholdings to preserve long term business relationships, regardless of operating and share performance. This coupled with assured life-time employment make executives and officers complacent to perform affecting the firm profitability.

A recent wave of corporate scandals has highlighted poor corporate governance standards in Japan shuttering the sense of "déjà vu all over again".

"Corporate governance is a problem in Japan. It ranks 33rd among 38 countries for corporate governance (according to GMI, a firm that measures such things) making it worse than Russia, Brazil and China. CLSA, a broker, complains that Japanese firms "express hostility to reforms". Regulators are mediocre. There is no requirement for independent directors".[39]

3.8 Recent Japanese Corporate Governance Problems

Olympus	2011	Illegal payments for acquisitions and hiding losses
Tepco	2011	Ineffectual Managers kept in place after nuclear disaster
Toyota	2010	Bad Quality, Board failed to act, Market Capitalisation falls $34 billion
Livedoor	2006	Internet Entrepreneur cooks books
Nikko	2006	Accounting Scandal

[39] Economist, 22nd October 2011

The basic elements of these scandals are: lack of transparency, accountability, and independence of boards. A case in point is that of Olympus.

Case of Mis-governance in Japan- OLYMPUS (2011)

Olympus was founded in Japan in 1919 as a microscope maker. It branched into cameras in the 1930s and later expanded into gastro cameras which captured 70 percent of the global market.

The Scam

The scandal at the camera and medical equipment maker involves several senior company managers, including former chairman Tsuyoshi Kikukawa, former executive vice president Hisashi Mori and former auditor Hideo Yamada. Three external advisers, Akio Nakagawa, NobumasaYokoo and TakuHada, were also charged in connection with the fraud.

In October 2011, the company removed two presidents, with its share price plummet by almost 75 percent, and came under investigation from regulators and enforcement agencies across the globe. The furore exploded following the discovery of payments for acquisitions completed between 2006 and 2008. CEO and President Michael Woodford, who brought the matter to the company's attention, were fired. Olympus cited differences over management style, while Mr. Woodford says he was fired for challenging the board over irregular business practices.

In October 2011, Olympus admitted executives hiding losses on the securities investment incurred in the late 1980s. The losses were hidden as long as 20 years. At the centre of the cover up were four deals made between 2006 and 2008. In this period Olympus acquired three firms – Humalabo, a producer of nutritional supplements; Altis, a waste disposal and recycling firm; and News Chef, a seller of microwave cooking ware and asset management firm. These companies were bought for a combined $773m, written down to just $187m in 2009. Much of the near $1bn that Olympus spent on these three Japanese start-up firms went to Cayman Islands-based companies that were dissolved or closed down shortly after receiving the money, according to internal documents and Cayman Islands records[40].

The fourth deal, the $2.2 billion purchase of UK medical firm, Gyrus Group, proved to be the most controversial. Olympus reportedly paid $687million in fees to two advisory companies related to the purchase – more than a third of the purchase price. The money went to New York firm AXES, and AXAM, a firm incorporated in the Cayman Islands. While payments to advisers

[40]Atkins, Matt (2011), The Olympus Controversy: A Snapshot Of Fraudwww.financierworldwide.com/article.php?id=8798, December 2011

in takeovers are normal, they typically range between 1 to 2 percent of the purchase price. In this case, fees in the region of $20m to $40m would be expected[41].

The unusual transactions were highlighted early in 2011 by the Japanese magazine Facta. A follow up story by another magazine, Zaiten, also exposed the failures of Olympus's investment branch, ITX. This media scrutiny led to Mr Woodford's examination of company records, and by 11 October he had suggested in a memo that Olympus chairman Tsuyoshi Kikukawa resigns in light of the errors of the firm. At a board meeting three days later, however, Mr. Woodford was himself relieved of his position.

The admission shocked investors and shares skidding down nearly 30 percent. Olympus in December 2011 filed five years' worth of corrected financial statements plus overdue first-half results, revealing a $1.1 billion dent in its balance sheet.

The three former executives had been identified by an investigative panel, commissioned by Olympus, as the main suspects in the fraud, seeking to delay the reckoning from risky investments made in the late-1980s bubble economy. Tokyo prosecutors arrested ex-president Tsuyoshi Kikukawa, former executive vice president Hisashi Mori and former auditor Hideo Yamada on suspicion of violating the Financial Instruments and Exchange Law[42], in February 2012. Also apprehended were former bankers Akio Nakagawa and Nobumasa Yokoo and two others suspected of helping hide huge investment losses through complex takeover deals at the endoscope and camera maker.

Shareholder Reaction

Shareholders reacted with anger and astonishment. On news of the cover-up, shares dropped 30 percent. Southeastern Asset Management, a 5 percent shareholder and Olympus' largest foreign investor, demanded the resignation of the entire board and urged the Japanese authorities to keep up pressure on the firm, and resist de-listing the firm as means of a swift and painless solution. Southeastern also called for an unprecedented meeting of Olympus shareholders to discuss removing the firm's directors and internal-audit board.

UK fund manager Baillie Gifford & Co., holder of 4 percent of Olympus shares, suggested that ousted CEO Woodford should return to the company to lead a clean-up operation. "Some large investors preferred to offload their holdings altogether, distancing themselves from the troubled firm. Singapore's sovereign wealth fund, Government of Singapore Investment Core (GIC), sold most of its holdings in the company. The fund was the tenth largest shareholder in Olympus.

[41]Op. cit.
[42]www.reuters.com/article/2012/02/16/us-olympus-idUSTRE81E22120120216

Governance Issues

The scandal raises questions about corporate governance, legislation, and business culture in Japan. At the time that Olympus invested in the three firms, both Humalabo and Altis shared the same address – a fact which alone should have raised concerns. In addition, all three firms shared the same auditor – Minoru Tanaka of accounting firm Rekorute, which had been given a rating by commercial credit rating service Tokyo Shoko Research that suggested the firm should be treated with some caution.

The scandal exposed the company's dismal record of corporate governance. Its board, stocked with insiders was unable to stop wrongdoing by top executives as many of the directors were “yes-men".

In Japan, directors are typically chosen from company insiders who have climbed the corporate ladder. This tradition has created a corporate culture that makes directors feel uneasy about criticizing the behavior of previous management teams that may have promoted them and saying things that are uncomfortable to the current top executives.

Mr. Woodford strongly criticised corporate practice at the firm. “The whole board is contaminated and that company needs to cleaned out,”[43]. “The whole board has had discussions and vote unanimously and no one asks anything. It’s just complete and utter obedience to Kikukawa.”

The scam also exposes weaknesses in the auditing function. Olympus’s auditor in the 1990,s was the Japanese affiliate of Arthur Andersen. After Andersen collapsed in 2002 following Enron debacle, KPMG took over Olympus audit which operated under the name Asahi & Co. KPMG remained the auditor through 2009 till Ernst & Young replaced them[44]. It raises the crucial question of ‘what the auditors doing’? The company hid losses by treating them as assets and the company had been doing so since the 1990s.

References

Ahmadjian, Christina L. and Ariyoshi Okumura (2011) ‘Corporate Governance in Japan’ In *Handbook on International Corporate Governance: Country Analysis (2nd Edition)* Ed Christine A. Malin, Edward Elgar

Atkins, Matt (2011), The Olympus Controversy: A Snapshot of Fraudwww.financierworldwide.com/article.php?id=8798, December 2011

Das, S.C. (2010), *‘Corporate Governance: Codes, Systems, Standards and Practices.* PHI Learning

[43]Atkins (2011)
[44] Economics Times, New Delhi 11-11-2011

Economics Times, New Delhi 11-11-2011

Economist, 22nd October 2011

Kensy,Rainer (2011) *Keiretsu Economy--New Economy?: Japan's Multinational Enterprises from a Postmodern Perspective* Palgrave Macmillan

Miyajima, H. and Kuroki, F. (2005) 'Unwinding of cross-shareholding: Causes, effects, and implications', RIETI Discussion Paper Series 05-E-006.

Moerland,Pieter W. (1995)Corporate Ownership and Control Structures: An International Comparison*, Review of Industrial Organization*August 1995, Volume 10, Issue 4, pp 443-464

Okumura, H. (2000) *Corporate Capitalism in Japan*. London: Palgrave Macmillan.

Sakurai, Michiharu (2010) 'Management Perception on Reputation Management in Japan', *The Accounting Research*, No.53/Winter, Accounting Research Institute,

Sakurai Michiharu (2011) 'Impact of Toyota Recall on Corporate Reputation' *ejournal.narotama.ac.id*

World Fact Book, CIA (https://www.cia.gov/library/publications/the-world-factbook/geos/ja.html)

www.reuters.com/article/2012/02/16/us-olympus-idUSTRE81E22120120216

4

CORPORATE GOVERNANCE IN MALAYSIA

4.1 Country Analysis

Malaysia is a federal constitutional monarchy. It achieved independence in 1957. Since independence, Malaysia has had one of the best economic records in Asia. Malaysia is a relatively open state-oriented and newly industrialised market economy. The state plays a significant role in guiding economic activity through macro-economic plans. The economy has traditionally been fuelled by its natural resources but has now expanded to medicine, commerce, science and tourism.

Since the late nineteenth century, Malaysia had been a major supplier of natural products like rubber, oil, timber etc to industrialised economies. But from 1970 onwards, the leading sector in development has been the export oriented manufacturing industries such as textile, electronic goods, rubber products etc. By the year 1990, the country had largely met the criteria of a newly industrialised country.

The Asian financial crisis originated in heavy speculation of international currency leading to major slumps in exchange rates severely affecting the banking and financial sectors. The Malaysian ringgit exchange rate fell from RM 2.42 to 4.88 US Dollar by January 1998. This led to a heavy outflow of foreign capital. To deal with this crisis[45], the Malaysian government took measures independent of IMF. National Economic Recovery Plan was launched in July 1998 with a view to stabilise the Malaysian currency, restoring the market confidence, restructuring corporate debt and the banking sector.

Even though the Asian crisis slowed the growth of Malaysia temporarily, the current plan, titled Vision 2020, aims to achieve a fully industrialised economy by then.

4.2 Regulation of Corporate Governance in Malaysia

Corporate governance system in Malaysia is broadly based on the Anglo-Saxon model. Many of the listed companies in Malaysia are family owned and controlled. The main regulator of companies is the Companies Commission of Malaysia. The primary legislation concerned with corporate activity in Malaysia is the Companies Act, 1965 which is based on the UK Companies Act of 1948. The Companies Act is supplemented by the Capital Markets and Services Act 2007

[45] How Malaysia weathered the Financial crisis: Policies and Possible lessons
Mah-Hui Lim and Soo-Khoon Goh (http://www.nsi-ins.ca/wp-content/uploads/2012/09/2012-How-to-prevent-the-next-crisis-Malaysia.pdf)

and the Securities Commission Act 1993 which helps to regulate the public companies and the capital markets. There are also various other subsidiary legislations, codes and guidelines, including the Malaysian code on takeovers and mergers 1998 and the guidelines on the regulation of assets, mergers and takeovers[46].

4.3 Code on Corporate Governance

The Securities Commission under the Ministry of Finance regulates the capital market in Malaysia. The Kuala Lumpur Stock Exchange (KLSE) enforces the listing requirements of the listed companies. After the collapse of the Malaysian economy in 1997 following the East-Asian crisis, the government appointed a High Level Finance Committee on Corporate Governance to establish a new framework for corporate governance. The Committee developed the Malaysian Code on Corporate Governance (Code) in March 2000. The Code based on self-regulation on the lines of the Cadbury Code, set out the principles and best practices on structures and processes of corporate governance such as board composition, board responsibilities, board committees, and recruitment and training of directors.

The Malaysian Code was revised in 2007 to strengthen Malaysia's corporate governance framework and bring it in line with current global best practice.

'Key amendments to the Code are aimed at strengthening the board of directors and audit committees, and ensuring that the board of directors and audit committees discharge their roles and responsibilities effectively. The amendments spell out the eligibility criteria for appointment of directors and the role of the nominating committee. On audit committees, the amendments spell out the eligibility criteria for appointment as an audit committee member, the composition of audit committees, the frequency of meetings and the need for continuous training. In addition, internal audit functions are now required in all PLCs and the reporting line for internal auditors clarified.' (Malaysian Code on Corporate Governance, Revised 2007)

The revised Code sets out three forms of recommendations: first, broad principles of good corporate governance which are on directors, director's remuneration, shareholders, and accountability and audit; second, best practices for companies which identify a set of guidelines or practices intended to assist the companies in designing their approach to corporate governance; and the third part is addressed to investors and auditors to augment their role in corporate governance. As in the Code of 2000, the listing requirements of Bursa Malaysia require all listed companies to state in their annual report how they have applied the principles of good corporate governance and the extent to which they have complied with the best practices giving reasons on area of non-compliance.

Salient provisions of the Revised Code 2007 are as follows:

[46]Salim, M. R., ' Corporate Governance in Malaysia: the Macro and Micro Issues'

Principles of Corporate Governance

- Every listed company should be headed by an effective board which should include a balance of executive directors and non-executive directors (including independent non-executives).
- There should be a formal and transparent procedure for the appointment of new directors to the board.
- Levels of remuneration of directors should be sufficient to attract and retain the directors needed to run the company successfully.
- The company's annual report should contain details of the remuneration of each director.
- Companies should use the AGM to communicate with private investors and encourage their participation.
- The board should present a balanced and understandable assessment on the company's position and prospects.
- The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.
- The board should establish formal and transparent arrangements for maintaining an appropriate relationship with the company's auditors.

Best Practices in Corporate Governance

- The board should explicitly assume the following six specific responsibilities to discharge the board's stewardship responsibilities:
  - Reviewing and adopting a strategic plan for the company
  - Overseeing the conduct of the company's business
  - Identifying principal risks and ensuring the implementation of appropriate systems of managing risk
  - Succession planning, including appointing, training, fixing the compensation of senior management
  - Developing and implementing an investor relations programme
  - Reviewing the adequacy and the integrity of the company's internal control systems
- To ensure a balance of power and authority, positions of chairman and chief executive officer should be separated. Where the roles are combined there should be a strong independent element on the board. A decision to combine the roles of chairman and chief executive officer should be publicly explained.
- Independent non-executive directors should make up at least one-third of the board membership. Where a company has a significant shareholder (a shareholder with the ability to exercise a majority of votes for the election of directors), then the board should include a number of directors which fairly reflects the investment in the company by the minority shareholders.

- The board should identify a senior independent non-executive director to whom concerns may be conveyed.
- The board of should appoint a committee of directors composed exclusively of non-executive directors, a majority of whom are independent, for proposing new nominees to the board and for assessing directors on an ongoing basis. The nominating committee should annually review its required mix of skills and experience and other qualities, including core competencies which nonexecutive directors should bring to the board. This should be disclosed in the annual report.
- Every board should examine its size, with a view to determining the impact of the number upon its effectiveness.
- As an integral element of the process of appointing new directors, each company should provide an orientation and education programme for new directors.
- The board should meet regularly, record its deliberations and the conclusions in discharging its duties and responsibilities. Number of board meetings held a year and the details of attendance of each director be disclosed.
- The board should have a formal schedule of matters specifically reserved to it for decision.
- Directors should have access to all information within a company whether as a full board or in their individual capacity, in furtherance of their duties.
- Directors should be enabled to take independent professional advice at the company's expense, if necessary.
- Boards should appoint remuneration committees, consisting wholly or mainly of nonexecutive directors, to recommend to the board the remuneration of the executive directors in all its forms, drawing from outside advice as necessary.
- The board should establish an audit committee comprising at least three members, a majority of whom are independent. All members of the audit committee should be non-executive directors. The board should provide the audit committee with written terms of reference which deal clearly with its authority and duties.
- All members of the audit committee should be financially literate and at least one should be a member of an accounting association or body.
- The duties of the audit committee should include: consideration of the appointment of the external auditor and audit fee; reviewing the quarterly and year-end financial statements to examine the going concern assumption and compliance with accounting standards and other legal requirements; reviewing the adequacy of the scope, functions and resources of the internal audit function; considering any related-party transactions that may arise within the company or group; and considering the major findings of internal investigations and management's response.
- The finance director, the head of internal audit and a representative of the external auditors should normally attend meetings. The committee should meet with the external auditors without executive board members present at least twice a year.

- The chairman of the audit committee should engage on a continuous basis with senior management and the external auditors to be informed of matters affecting the company.
- The board should disclose details of the activities of audit committees, the number of audit meetings held in a year, details of attendance of each director in the meetings, and the details of relevant training attended by each director.
- The board should establish an internal audit function.
- The boards should maintain an effective communications policy that enables both the board and management to communicate effectively with its shareholders, stakeholders and the public.

- **Principles and Best Practices for other Corporate Participants**

- Institutional shareholders have a responsibility to make considered use of their votes.
- Institutional investors should encourage direct contact with companies, including constructive communication with both senior management and board members about performance, corporate governance, and other matters affecting shareholders' interest.
- The external auditors should independently report to shareholders in accordance with statutory and professional requirements.

(Source: Malaysian Code on Corporate Governance (Revised 2007), Securities Commission)

Revision in the Code- Malaysian Code on Corporate Governance 2012

The Code of Corporate Governance 2007 was replaced by the *Malaysian Code on Corporate Governance 2012* (MCCG 2012). The new code sets out broad principles and specific recommendations on structures and processes which companies should adopt in making good corporate governance an integral part of their business dealings and culture. This code focuses on clarifying the role of the board in providing leadership, enhancing board effectiveness through strengthening its composition and reinforcing its independence. It also encourages companies to put in place corporate disclosure policies that embody principles of good disclosure. Companies are encouraged to make public their commitment to respecting shareholder rights.

Listed companies are required to report on their compliance with the principles and recommendations of the MCCG 2012 in their annual reports. Companies are however encouraged to make an early transition to the principles and recommendations elaborated in this new code.

The Code lays down eight principles and their corresponding 26 recommendations. The principles and recommendations focus on, amongst others, laying a strong foundation for the board and its committees to carry out their roles effectively, promote timely and balanced

disclosure, safeguard the integrity of financial reporting, emphasise the importance of risk management and internal controls and encourage shareholder participation in general meetings.

Principle 1 – Establish clear roles and responsibilities

- The board should establish clear functions reserved for the board and those delegated to management.
- The board should establish clear roles and responsibilities in discharging its fiduciary and leadership functions.
- The board should formalise ethical standards through a code of conduct and ensure its compliance.
- The board should ensure that the company's strategies promote sustainability.
- The board should have procedures to allow its members access to information and advice.
- The board should ensure it is supported by a suitably qualified and competent company secretary.
- The board should formalise, periodically review and make public its board charter.

Principle 2 – Strengthen composition

- The board should establish a nominating Committee which should comprise exclusively of non-executive directors, a majority of whom must be independent.
- The nominating Committee should develop, maintain and review the criteria to be used in the recruitment process and annual assessment of directors.
- The board should establish formal and transparent remuneration policies and procedures to attract and retain directors.

Principle 3 – Reinforce independence

- The board should undertake an assessment of its independent directors annually.
- The tenure of an independent director should not exceed a cumulative term of nine years. Upon completion of the nine years, an independent director may continue to serve on the board subject to the director's re-designation as a non-independent director.
- The board must justify and seek shareholders' approval in the event it retains as an independent director, a person who has served in that capacity for more than nine years.
- The positions of chairman and CEO should be held by different individuals, and the chairman must be a non-executive member of the board.
- The board must comprise a majority of independent directors where the chairman of the board is not an independent director.

Principle 4 – Foster commitment

- The board should set out expectations on time commitment for its members and protocols for accepting new directorships.

- The board should ensure its members have access to appropriate continuing education programmes.

Principle 5 – Uphold integrity in financial reporting

- The audit Committee should ensure financial statements comply with applicable financial reporting standards.
- The audit Committee should have policies and procedures to assess the suitability and independence of external auditors.

Principle 6 – Recognise and manage risks

- The board should establish a sound framework to manage risks.
- The board should establish an internal audit function which reports directly to the audit Committee.

Principle 7 – Ensure timely and high quality disclosure

- The board should ensure the company has appropriate corporate disclosure policies and procedures.
- The board should encourage the company to leverage on information technology for effective dissemination of information.

Principle 8 – Strengthen relationship between company and shareholders

- The board should take reasonable steps to encourage shareholder participation at general meetings.
- The board should encourage poll voting.
- The board should promote effective communication and proactive engagements with shareholders.

(Source: Securities Commission, Malaysia, March 2012)

4.4 Companies Amendment Act 2007

The revision of corporate governance code in 2007 was reinforced with amendment in the companies Act in 2007 to enhance corporate governance in Malaysia. Some of the amendments were:

- Expansion of the duty of directors to disclose interests
- Prohibiting interested directors form voting
- Clarification of directors' functions and duties
- Widening the scope of duty of skill, care and diligence
- Clarification of the functions, duties and responsibilities of nominee directors

- A prohibition on related party transactions except where there is prior approval by disinterested shareholders
- Allowing companies to conduct shareholders' meetings electronically
- Requiring public companies to establish a system of internal control
- Requiring auditors of public companies to report on serious offences involving fraud and dishonesty and affording protection to auditors on genuine reports made in good faith
- Requiring auditors to report to the Registrar, and to Bursa Malaysia, the grounds of their removal, registration or declination of reappointment
- Introducing the statutory derivative action to facilitate redress against oppression of the minority
- Introducing a whistle blowing provision to afford protection to officers who report on contraventions or serious offences involving fraud and dishonesty

The Companies Commission of Malaysia also established the Companies Commission of Malaysia Training Academy in 2007 to promote a new breed of corporate directors with adequate knowledge of obligations under the company law.

Audit Oversight Board

In line with the Sarbanes-Oxley Act, Malaysia has established the Audit Oversight Board (AOB) to strengthen the independent oversight of auditors. It was established under the Securities Commission Act 1993. Its mission is to assist the securities commission in overseeing the auditors of public interest entities and protect the investors by promoting confidence in the audited financial statements of such entities. Its duties include registering auditors of public interest entities and to monitor them in order to ascertain the extent of their compliance with the recognised standards. The AOB can also sanction any registered auditor for failure to comply with standards. In September 2010, Malaysia was admitted as a member of the International Forum of Independent Audit Regulators. This was a formal recognition of Malaysia's AOB as a well-structured and independent audit regulator.

Promoting Shareholder Activism

One of the important capital market institutions in Malaysia is the Minority Shareholder Watchdog Group (MSWG), a body set up in 2000. This body has been actively encouraging minority shareholders to play their role in ensuring that managements are running business in the best interests of all and to voice their concerns in case they do not think so.

The primary approach of MSWG is to actively engage with boards and managements of public interest entities on issues related to financial performance, corporate governance and corporate social responsibility. This is done through attendance at annual general meetings, where questions are raised to the board for the benefit of minority shareholders.

MSWG's annual Malaysian Corporate Governance Index helps to create awareness about the best practices adopted by various public listed companies in Malaysia. The various areas identified through this index which need attention are:

- Role of independent directors
- Separation of powers between chairman and CEO
- Director's remuneration
- Board performance appraisal
- Risk management
- Poll and proxy voting

4.5 Issue of Corporate Governance in Malaysia

In the area of corporate governance, Malaysia does seem to have all the important laws in place and conforms to most of the best practices followed internationally. Corporate governance reforms in Malaysia are driven more by regulations. In the face of poor public governance and politics-business nexus in Malaysia which is well documented[47], the state of corporate governance remains unchanged.

Malaysia has shown a good attempt at building effective and comprehensive rules for corporate governance. The surveys have also shown a decent level of compliance. But yet, it suffers from various institutional loopholes. Poor enforcement is one of the key issues. This could be due to reasons which are typical of any developing nation such as inefficient allocation of resources, lack of transparency and corruption.

Leadership, board roles and board quality are areas which receive inadequate emphasis in corporate governance regulations[48]. Although, the laws have been amended and codes of corporate governance have been laid down on the lines of Anglo-Saxon norms, the legal institutions and enforcement bodies are marked by inefficiencies and corruption[49]. A study conducted by Standard and Poor's (2004) also revealed that most of the companies in Malaysia still fell short of global disclosure practice. 'In Malaysia, annual reports are seen to be less effective in conveying useful information to users due to the disclosure of information that is no longer relevant or that current users demand more from the contents of annual reports'[50].

---

[47] Salim, M. R., ' Corporate Governance in Malaysia: the Macro and Micro Issues'
[48] Op cit

[49] Aida Maria Ismail (2010), 'Corporate Governance Dilemma - Evidence from Malaysia' Finance and Corporate Governance Conference 2010 Paper http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1541788
[50] Op cit

1. **Issues on Family and Government Linked Companies**

Malaysian companies are highly concentrated, with strong control by the founder families and their descendants. A unique feature of corporate ownership in Malaysia is that majority of shareholdings in Public Listed Companies is by the nominee companies and institutions (finance and non-financial companies) owned by families. This composition of ownership has changed a little over time in Malaysia[51]. Zhuang et al found that since 1997, nominee companies held 45.6 % of total shares of an average non-financial Public Listed Company by the top 5 shareholders. Zuriawati et al[52] in their study in 2014 also reported that the mean percentage of the five largest shareholders was 51.74% implying that more than 50% of the share ownership was held by top five Malaysian companies' shareholders.

Shareholders in Malaysia opt for nominees to conceal their identity. Interlocking stock ownership and interlocking directorates are the most common mechanisms in Malaysia which strengthen the ownership and control of families over corporations. This results in a reluctance to involve outsiders to finance growth especially when it results in the families losing control and the notion that outsiders might change the way the business is governed. This has implications for independent directors in Malaysia who may prefer the interest of controlling shareholders rather than of the company as a whole. Studies have found that close to 10% of listed companies have failed to comply with the one third proportions of independent directors as recommended by the Malaysian Code on Corporate Governance.

Beside concentration of ownership and managerial ownership, government-controlled institutions also hold significant shares in the Malaysian listed companies. In the wake of privatisation, many of the government owned companies were listed on the Bursa Malaysia. But the government has retained control over these companies either through a controlling stake or special right shares bestowing special rights to the government through appointing nominee directors on the board or veto rights to the government[53]. In many publicly listed government linked companies, the requirement for a larger number of independent directors has come at an expense of managerial participation in the board. It is common to find a large number of directors who are nominees of government and other large shareholders, sometimes even including the chairperson. Such an act puts the government in power and compromises on the board's ability to make best decisions in the interest of the company.

---

[51] Zhuang J., D. Edward and MV Capulong (2000), 'Corporate Governance and Finance in East Asia- A study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand, *Asian Development Bank*

[52]Zuriawati Zakaria, Noorfaiz Purhanudin, Yamuna Rani Palanimally (2014) 'Ownership Structure and Firm Performance: Evidence from Malaysian Trading and Services Sector' *European Journal of Business and Social Sciences*, Vol. 3, No.2 , pp 32-43, May 2014.

[53] Salim, M. R., ' Corporate Governance in Malaysia: the Macro and Micro Issues'

2. **Shareholders' Meetings**

The exercise of shareholder's voice is an essential aspect of shareholder's activism. Shareholders' meeting is one way in which minority shareholders can fight for themselves. This highlights the need for a legal regime where the law facilitates shareholders' participation in the company's affairs. But this area seems to have been highly neglected in Malaysia.

The law on requisition for an extraordinary general meeting can be used as a useful tool by minority shareholders to discuss important issues. Unfortunately the law in this respect seems to be a lot in favour of the corporate controllers especially with regard to the costs of requisition[54]. Also there is absence of a cumulative voting provision in the companies' legislation. This is an important weapon especially for large minority shareholders, which allows them to place their representative son boards to monitor management performance. However, there is a need to study the implications for introducing such a rule.

3. **Remedies to Shareholders**

In every corporate governance structure, it can be found that there are laws which help the shareholders to get their grievances addressed and move lawsuits in order to get their rights enforced. Malaysia seems to have many comprehensive laws in this regard. There are provisions for oppression or unfair discrimination. Shareholders also have the option to apply for winding up of the country if it is validly proved that directors have acted in their own interests[55]. The oppression rule is particularly useful to the minority shareholders as it allows the courts to make a wide range of orders. Also there is the derivative action option which allows shareholders to bring an action on behalf of the company against the directors of the company.

There are however, some limitations. The oppression remedy was designed for shareholders in small companies and remains limited to them mostly. Very rarely is there a case involving a public company. Also, the winding up remedy is not used until it becomes the last resort as the courts are always keen to balance the interests of the complaining shareholders with those of the other shareholders. Also the quality of decision making gets highly affected as the courts find themselves in an unfamiliar territory when dealing with corporate problems. Even the derivative action option has remained ineffective due to the complexity of rules and a number of procedural barriers before exercising this option.

ASTRAL ASIA BERHAD - A CASE

On 7 June 2006, the Bursa Securities announced a public reprimand of the directors of Astral Asia Berhad with regard to information in the company's Annual Report which were misleading. The misleading information was in relation to the number of board of directors meetings and audit committee meetings which were held for the financial year ending 31 December 2004.

[54] Op cit
[55] Op cit

Part I of the Malaysian Code on Corporate Governance contains the principles of Corporate Governance and Principle AI states that: "every listed company should be headed by an effective board which should lead and control the company."

In Part II of the Code, as part of best practice to ensure that there is an effective board, under Best Practice AA III, it is stated that: " the board should meet regularly, with due notice of issues to be discussed and should record its conclusions in discharging its duties and responsibilities. The board should disclose the number of board meetings held a year and the details of attendance of each individual director in respect of meetings held"

The company stated in its Annual report that there were 6 board meetings and 6 Audit committee meetings held during that period. But it was found that Astral actually held only 1 board meeting. No audit committee meetings were ever held.

Bursa Securities then issued a public reprimand against the company and imposed a heavy fine on the directors of the company. The basis of the enforcement action was that the directors had permitted, either knowingly or where they had reasonable means of obtaining such knowledge, the company to breach the Listing Requirements in relation to the disclosure of information in the Annual Report 2004 relating to the number of board meetings and audit committee meetings held.

The public reprimand were also imposed on the directors who were the members of the audit committee for causing the company to breach the Listing Requirements by not ensuring that the company's audit committee discharge its functions as stated in the Annual Report 2004.

Despite the board having a good board composition in terms of number of executive and independent non-executive directors, the independent non-executive directors were clearly ineffective highlighting the fact that ensuring 'independence' of directors is a continuous process and a director's categorization as "independent" does not ensure that there is actual independence.

The 2004 Annual Report did not only state that there were 6 audit committee meetings held but also stated that all the audit committee members had recorded full attendance at the audit committee meetings when actually there were no audit committee meetings held.

This scenario put a question whether the duty of skill, care and diligence had been at all discharged by the company board. This case gave a view that only following the corporate governance structure may not be enough to prohibit people from intentionally not discharging their duties. In such a circumstance, the punitive element of law should be put into practice. Even though the action taken by the Bursa securities was well accepted but it also brought forth teh issue that the fine was imposed against the company and not the persons actually responsible for the default.

One enforcement power that is available but has not been effectively utilised by the regulatory authorities in Malaysia is the disqualification provisions in the Companies Act 1965 as well as the Securities Industry Act 1983. Through this, wherever there has been a breach of the Listing Requirements by the directors, and an application is made by the Securities Commission, The Stock Exchange or a recognized clearing house to the court, the court may make an order for him to be removed from office or be barred from being involved in the management of other public companies. From a comparative perspective, UK and Australia have consistently utilized the directors' disqualification provision in the corporate and securities regulation.

References

Bushan, R. B. (2010), 'Corporate Governance Developments in Malaysia', *Corporate Governance Asia*

Ismail, Aida Maria (2010), Corporate Governance Dilemma - Evidence from Malaysia' Finance and Corporate Governance Conference, 2010.

Lim, Mah-Hui and Soo-Khoon Goh (2012) 'How Malaysia weathered the Financial Crisis: Policies and Possible Lessons' (http://www.nsi-ins.ca/wp-content/uploads/2012/09/2012-How-to-prevent-the-next-crisis-Malaysia.pdf)

Salim, M.R, (2011), 'Corporate Governance in Malaysia: The Macro and Micro Issues', In: Christine A Mallin, ed., *Handbook on International Corporate Governance: Country Analyses* 2nd edn. Edward Elgar.

Sulaiman Alnasser, (2012) "What has changed? The development of corporate governance in Malaysia", *The Journal of Risk Finance*, Vol. 13 Iss: 3, pp.269 - 276

Zhuang J., D. Edward and MV Capulong (2000), 'Corporate Governance and Finance in East Asia- A study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand, *Asian Development Bank*

Zuriawati Zakaria, Noorfaiz Purhanudin, and Yamuna Rani Palanimally (2014) 'Ownership Structure and Firm Performance: Evidence from Malaysian Trading and Services Sector' *European Journal of Business and Social Sciences*, Vol. 3, No.2 , pp 32-43, May 2014.

5

SOUTH KOREA

5.1 Country Profile

South Korea, the fourth-largest economy of Asia is one of the highest ranked countries in terms of education, healthcare, human development, ease of doing business and job security. It is the world's most research and development intensive country[56] and the most innovative country as measured by the Bloomberg Innovation Quotient[57]. As per the World Bank, exports made up 53 percent of the Korean economy in 2011, one of the highest rates globally. South Korea is the leading exporter of memory chips and flat panel displays.

South Korea over the past four decades has demonstrated incredible growth and global integration to become a high-tech industrialised economy. Initially, a close economy with import restrictions and controlled credit, the government of South Korea promoted the import of raw materials and technology at the expense of consumer goods, and encouraged savings and investments over consumption.

The Asian financial crisis of 1997-98 exposed longstanding weaknesses in South Korea's development model including high debt/equity ratios and massive short-term foreign borrowing. GDP plunged by 6.9% in 1998, and then recovered by 9% in 1999-2000. South Korea adopted numerous economic reforms following the crisis, including greater openness to foreign investment and imports. Throughout 2012 and 2013 the economy experienced sluggish growth because of market slowdowns in the United States, China, and the Eurozone.

The South Korean economy's long term challenges include a rapidly aging population, inflexible labor market, dominance of large conglomerates (*chaebols*), and heavy reliance on exports[58].

5.2 Corporate Governance in South Korea

Corporate governance system in South Korean is primarily family-based. The *chaebols* which are diversified, family-owned business groups dominate the Korean economy. *Chaebols* originated following the Second World War, when the government targeted strategic industries for import substitution and firms diversified aggressively into these industries to take advantage of preferential credit allocations, tax benefits and protection from foreign competition.

Chaebols played a crucial role in transforming war-torn South Korea into a wealthy, dynamic economy in less than four decades. Beginning 1960s *chaebols* grew tremendously from the

---

[56] OECD Science Technology and Industry Outlook 2014

[57] http://www.bloomberg.com/slideshow/2014-01-22/30-most-innovative-countries.html#slide32

[58] https://www.cia.gov/library/publications/the-world-factbook/geos/ks.html

production of a diversity of goods. Innovation and the willingness to develop new product lines were the business strategy of *chaebols* . In the 1960s, *chaebol* concentrated on wigs and textiles; by the mid-1970s and 1980s, heavy, defense, and chemical industries became predominant. The real growth occurred in the electronics and high-technology industries in 1990s. In 1996, the top thirty *chaebols* accounted for 40% of GNP, while the top 5 *chaebols* accounted for 58% of the total assets of these top thirty *chaebols*[59].

*Chaebols*are charaterised by concentrated ownership of the business by the founder and his family through cross shareholdings and mutual debt guarantees, a highly diversified business structure and high levels of debt-equity ratios. They are often involved in a variety of industries ranging from banking and insurance, to electronics, automobile production and ship building. They wield a considerable influence in Korea. Well known *chaebols* of Korea are Samsung, Hyundai, Lucky-Goldstar (LG), Hanjin and SK Corp.

Traditionally, *chaebols* were founded by one individual. The entire conglomerate remained under his control and it was usual for this control to pass on to the eldest son upon his retirement or demise. Chaebols resembled a family unit, where the employer was regarded as a parent who looked after the employees and their families – a typical reflection of the Confucian values which figure largely in Korean life.

Management within the *chaebols* is autocratic and dictatorial, with the all-pervading influence of the founder in corporate activities. Decision making is often centralised. In-group harmony, identity with the firm logo and loyalty to their employer are characteristics typical of employees, who are in turn rewarded and promoted on the basis of their seniority, and who can expect to stay with their firm until retirement age. These employee-friendly practices inspire them to sacrifice personal time in order to prioritise the business of the firm. This kind of *chaebols* contributed significantly to economic development in the years after the war – their founders invested vigorously in long term projects, led its export industry through the creation of brand names and created employment in the economy.

Difference between *chaebolsandkeiretsu*

The *chaebol* are different from Japanese *keiretsu* on at least three counts. First, the *chaebols* are family dominated. In 1990, for example, in most cases the family that founded the major business in the *chaebol* remained in control, while in Japan the *keiretsu* are controlled by professional corporate management. Second, individual *chaebol* were prevented from buying controlling shares of banks, and the Korean Government regulations made it difficult for a *chaebol* to develop an exclusive banking relationship. The *keiretsu* usually works with an affiliated bank which is the main bank and had almost unlimited access to credit. Third,

[59] Fair Trade Commission, 1996

the *chaebol* often formed subsidiaries to produce components for exports, while large Japanese corporations often employed outside contractors.

5.3 Flaws in Corporate Governance System of Korea

Although the *chaebol* have played a pivotal role in the country's development and economic success, the *chaebol* dominated corporate governance system of Korea has many weaknesses which came to surface in the aftermath of the Asian crisis of 1997. While the crisis was rooted in the severe crunch of foreign currency reserves, the structure of corporate governance powered with the *chaebols* was the contributory factor. The weaknesses of the *chaebol* system are:

- **Concentrated Ownership**
  A relatively high level of internal ownership creates the reluctance of owner-managers of companies to rely on equity finance on account of fear of losing control. It hampered development of capital market in Korea. Absence of market oversight and support of the government as an insurer or underwriter of large investment projects encouraged the *chaebols* to expand their businesses in riskier ventures without the needed prudence.
- **Lack of Transparency**
  Complex ownership structures in *chaebols* and cross-guarantee practices made the business activities and financial positions of *chaebols* opaque. They developed tendencies to keep profit levels deliberately low and business practices obscure. The CEO acting as the owner as well as the manager coupled with highly autocratic style of working enabled controlling shareholders to expropriate the interest of minority shareholders.
- **Control Rights Exceeding Cash-Flow Rights**
  *Chaebols*are characterised by indirect control over business entities through cross-holdings. They were having indirect control over institutional investors also which resulted in control rights exceeding cash-flow rights. This control was often at the expense of other minority shareholders and expropriation of their interest. The founders of *chaebols* and their decedents were the controlling shareholders who enjoyed backing and patronage from the government. That gave rise to the agency problem between controlling shareholders and other minority shareholders.
- **Reckless Diversification Strategy**
  Chaebols were known for highly diversified business structures. The availability of easy finance and significant backing from the government led *chaebols* to go for unrelated diversification.
- **Highly Levered Structure**
  Chaebols riding on backing from the government and financial institutions including banks were highly levered. For example, by the end of 1996, average debt to equity ratio

of 30 largest *chaebols* was 400% which soared to 500% in 1997[60]. The priority of *chaebols* was growth over efficiency or profitability and their belief was that the government would bail them out and that they are “too big to fail” which led them to take large risk. The excessively levered *chaebols* were not prepared for the economic slowdown of 1997 and that triggered a serial bankruptcy in Korea in 1997.

- **Limited Role of Financial Institutions**
  Another deficiency in the corporate governance system was the lack of supervision from financial institutions over *chaebols.* Financial institutions as a debt provider should actively monitor and supervise debtors. The weakness in the system and high leverage was aggravated by the passive nature of the Korean banking system which had no role to play in governance of assisted companies. The banks and financial institutions, highly dependent on the government, had limited risk management and credit analysis skills. The financial institutions could not also exercise any discipline over *chaebols* on account of indirect control of the latter owing to cross shareholding.
- **Deficiency in Foreign Direct Investment**.
  The limited existence of foreign direct investment worsened Korea’s corporate governance. Foreign direct investment has not been able to function as potential entrants or raiders, nor as active shareholders in publicly held corporations.

5.4 Corporate Governance Reforms in Korea

The corporate governance reforms were undertaken in Korea after the Asian crisis under the Five Principles agreed between the government and the business leaders in January 1998. These were:

- Enhancement of corporate governance,
- Prohibition of cross-guarantees between business affiliates,
- Improvement of corporate financial structure,
- Business concentration on core competence,
- Responsibility reinforcement of governing shareholders and management.

Financial Re-structuring

A major priority of the Korean Government was to improve the financial structure of corporations. Firms were required to reduce their debt-to-equity ratio below 200% and by 2000, most *chaebols* met the target by issuing new shares and corporate bonds, rather than redeeming their debt. New cross guarantees were prohibited in April 1998, and all the existing cross guarantees were eliminated by March 2000. New stock issues jumped from 2.67 trillion won in 1997 to 13.45 trillion won in 1998, then surged to 33.42 trillion won in 1999.

[60] OECD (1999) Address by Oh-Seok Hyun at Conference on “Corporate Governance in Asia-A Comparative Perspective”

Transparency

To improve transparency, a number of reforms have been made in the accounting system in Korea after the financial crisis. Accounting principles that complied with international standards were introduced in December 1998, and in August 2000, consolidated financial statements were made mandatory for the 16 largest business groups. In the year 2002, penalties for fraudulent public disclosure by listed firms were increased[61]. The state enforced stricter responsibility for corporate failure by filing charges against managers of troubled corporations and financial institutions that had received public funds.

To reinforce independence of external auditors, top 30 *chaebols* and all listed companies were required in February 1998 to constitute "independent audit committee" represented by minority shareholders and creditors.

Accountability of the Management

Another improvement associated with the corporate governance reform was the reinforcement of accountability of the management. Independent directors were introduced for large, listed firms. Two years before the crisis, the government had attempted to mandate the listed firms to appoint at least 25% independent directors, but gave up in the face of strong opposition from large corporations[62]. In March 1998, the government introduced a requirement for at least one independent director for every listed firm. By October 1998 all 752 companies appointed 764 outside directors.

The revised Securities Trading Act of October 1999 further required more than 50% of board members (and at least three directors) of listed firms with more than 2 trillion won worth of assets to be independent. The new law also required firms to establish an audit committee, two thirds of the members of which were mandated to be independent, including the chairman. From the year 2000, firms were required to establish a nominating committee, one-half of whose members were to be independent. In 2001, this requirement was expanded to large KOSDAQ-listed firms.

To protect minority shareholders' rights, the Securities Trading Act was revised to lower the requirements for a shareholder derivative suit from a minimum of 1% of outstanding shares to 0.1%. In addition, laws were revised in December 1998 to regard a major shareholder as a *de facto* director.

Exit of non-viable firms

To address the exit of non-viable firms, bankruptcy related laws were amended in Korea in 1998 to simplify legal proceedings for corporate rehabilitation and bankruptcy filing. In addition, to discipline inefficient management corporate takeovers were made easier.

---

[61]Chung, 2002; MOFE, 2002
[62] Lee and Oh, 2001

One of the important leeways to activate those takeovers is the promotion of foreign direct investment. To this end, foreign direct investment was facilitated through revisions of related laws and all kinds of mergers and acquisitions were allowed in May 1998.

Foreign Direct Investment Facilitation Law was enacted to liberalise M&A by foreigners. By 2002, almost all sectors, excluding broadcasting, were open to foreign direct investment[63]. As a result, inward FDI increased from US$3.2 billion in 1996 to $15.5 billion in 1999[64].

With the liberalization of foreign investment, foreign ownership of shares of listed firms increased from less than 14% in 1997 to about 37% in 2001. By the end of 2002, 32 major corporations had more than 50% foreign ownership. Most foreign shareholders were institutional investors such as mutual funds and hedge funds. Multinational corporations also increased their presence by acquiring local firms.

Foreign institutional investors also exerted market-based pressure. Sales of shares or threats of sales, by foreigners forced a number of major corporations to cancel decisions that favored majority shareholders at the expense of foreign and minority shareholders.

Increased Shareholders' Activism

Growing shareholder activism through Non-governmental organizations (NGOs), particularly, the People's Solidarity for Participatory Democracy (PSPD) played a pivotal role in corporate governance reform. Shareholder activism had been nearly non-existent until 1997. PSPD initiated a major campaign on behalf of minority shareholders. Its first target was Korea First Bank; subsequently, it expanded its activities to elite *chaebol* corporations including Samsung Electronics, SK Telecom, and Hyundai Heavy Industries.

The PSPDs basic mode of operation was to raise questions at general shareholders' meetings, resulting in some very long and contentious meetings. PSPD also identified firms that were engaged in illegal activities. In 1999, Hyundai Heavy Industries partly agree to the PSPD by withdrawing their plan to support Hyundai Motors in its acquisitions of Kia Motors and Asia Motors.

5.5 Corporate Law in South Korea

South Korea has a mixed legal system combining European civil law, Anglo-American law, and Chinese classicalthought[65]. The Korean Commercial Code (KCC) is the main body of laws in Korea relating to business enterprises. The Commercial Code regulates the existence and the relationships of the enterprises that have the purpose of profit-making. It came into force on January 1, 1963. The Act has been amended several times.

[63]MOFE, 2002
[64] Chang and Jeon, 2000
[65]https://www.cia.gov/library/publications/the-world-factbook/geos/ks.html

Under the Korean Commercial Code, four basic corporate entities may be formed:

1. Partnership Company *(Hapmyong Hoesa)*- In a *Hapmyeong Hoesa* two or more partners form the partnership. The partners have unlimited liability. Every member bears the rights and responsibilities.
2. Limited Partnership Company (*Hapja Hoesa*)-In a *Hapja Hoesa* one or more partners may have unlimited liability and one or more partners may maintain limited liability. Unlimited liability members have the rights and responsibilities pertaining to the company business and its representation, while limited members participate in the company only through capital investment.
3. Limited Liability Company (*Yuhan Hoesa*)-*Yunhan Hoesa* is a closely held company that is prohibited from having more than 50 shareholders. The liability of the members is limited to the extent of their capital investment. Since there are many restrictions on this type of company, it is more suitable form for SMEs.
4. Stock Company (Corporation) (*Jusik Hoesa*)-*Jusik Hoesa* is the only form of corporate entity that is allowed to publicly issue shares. Almost 95% of companies in Korea are corporations. It is also the most common corporate form that foreign companies chose for their subsidiaries. Members (stockholders) of a corporation have limited liability, being liable only to the extent of their capital investment in the corporation made through the acquisition of its stocks. The stocks of a corporation may be freely transferable. However, the transfer of stocks could be subject to the decision of the board of directors in accordance with its articles of incorporation. The standing organization of a corporation includes the general meeting of stockholders which is the supreme decision making body, board of directors makes decisions on its operations, chief executive officer (CEO) executes company business and represents the company, and Statutory Auditor inspects company affairs and audit accounts). Decisions regarding the operations of a corporation are made by the board of directors.

With the spectacular failures of conglomerates such as Daewoo, Hanbo, Kia, and Daenong, the KCC was amended three times in 1995, 1998, and 1999 to correct the structural failure of corporate regulations on Korea. The purpose of amendment of 1995 was to "enhance the international competitiveness of Korean companies." The major focus of the 1998 amendments was to address the failures that were exposed during the financial crisis. The 1998 amendments included provisions to simplify the mergers and acquisitions process, increase the accountability of de facto directors, and strengthen minority shareholder rights. The 1999 amendments included regulations concerning stock options and audit committees. The latest amendments were made in 2012. The amended Commercial Code, among other things, provides added flexibility in issuing various securities and to promote M&A activities in Korea.

Regulatory Bodies

The Financial Services Commission (FSC) is the main supervisory and regulatory authority in Korea. The FSC enforcement agent is the Financial Supervisory Service (FSS).

5.6 Code of Corporate Governance in Korea

The Korean Committee on Corporate Governance was established as a non-government body in 1999 with financial backing by the Korea Stock Exchange, Korea Securities Dealers Association, Korea Listed Companies Association and Korea Investment Trust Companies Association. The Committee developed a Code of Best Practices to guide the Korean companies in establishing a proper corporate governance structure. The development of Code, in the opinion of the Committee, has taken into consideration the unique managerial circumstances faced by the Korean companies, and also the internationally accepted corporate governance principles and standards. The purpose of the Code as laid down is:

> "…… to maximize corporate value by enhancing the transparency and efficiency of corporations for the future. To gain the trust of shareholders and interested parties, the corporation must operate a transparent and reliable management. Based on such corporate transparency and reliable management, a managerial system that promotes creative and progressive entrepreneurship must be established".

To give flexibility to the companies, the Code is applicable on voluntary basis to listed companies and other public companies. However, non-public companies are also advised to follow the Code where applicable.

The Committee was re-constituted in 2002 to review the Code in view of the inadequacy of the Code stemming from various regulatory changes since taken place, and investors' (particularly foreign investors) concerns over the risk involved in investing in Korea. The investors suspicion about the transparency in corporate governance had particularly deepened with the large scale accounting frauds surfaced in the US and other countries of the world at the turn of the century. The Committee presented the revised code in 2003 which has attempted to harmonize the Code with the global standards and simultaneously to make it more realistic in the Korean context. The Code consists of five sections: Shareholders, Board of Directors, Audit Systems, Stakeholders, and Management Monitoring by the Market.

Code of Best Practices for Corporate Governance (2003)

- **Shareholders**
- Shareholder's rights such as to attend and vote at general meetings and to receive relevant information timely should be protected, and shareholders should be able to exercise their rights though appropriate procedures.

- Shareholders should be treated equitably under the principle of shareholder equality.
- Controlling shareholders should take the corresponding responsibilities when they exercise any influence toward corporate management other than the exercise of voting rights.

Board of Directors

- The Board of Directors should establish the business objectives and strategies and supervise the activities of the directors and management. The activities of the board should include: setting corporate goals and strategies; approving business plans and budgets; supervising risk management and appropriate disclosure of information.
- The directors and the Board should perform their duties faithfully in the best interests of the corporation and its shareholders; they should also fulfill their social responsibilities and take into account the interests of various stakeholders.
- The Board should observe the related statutes and the articles of incorporation when executing its responsibilities and ensure that all members of the corporation also observe them.
- The number of directors should be sufficient enough to facilitate meaningful discussions and appropriate, swift and prudent decision-making.
- The Board should include outside directors who are in a position to carry out their responsibilities independently from the management, controlling shareholders and the corporation to enable the Board to perform its management supervisory functions effectively. The number of outside directors should be a minimum of two. In the case of large listed corporations, half of its directors be composed of outside directors (minimum of three outside directors). However, a large listed controlled company of which more than 50% of the voting power is held by an individual, a group or another company does not need to have a majority of its board composed of outside directors.
- For a large listed corporation, it is advisable to appoint a person who is not a representative of management (i.e., chief executive officer) as chair of the board of directors. In the case where this recommendation cannot be accepted, it is desirable to elect an outside director who is in a position to act as a representative for other outsider directors.
- Directors should be appointed through a transparent process and it is advised that a nomination committee comprised of a majority of outside directors who would nominate the candidates be established to ensure the fairness and independence of the nomination process.
- A cumulative voting system be adopted to ensure the independence of directors and to reflect the shareholder’s diverse opinions (non-controlling shareholders) when appointing directors. It will also restrict the significant influence that controlling shareholders exert on the management. To encourage adoption of this system, its adoption or otherwise must be disclosed.

- The corporation should provide outside directors with information necessary to enable them to perform duties .To reinforce the outside director's management supervision and supporting functions, a regular meeting of outside directors be held separately from the board meetings
- The Board meetings should, in principle, is held regularly, at least once every quarter.
- The Board should establish committees establish an audit committee, nomination committee and compensation committee to function effectively. However, large controlled listed corporations must establish only an independent audit committee.
- A majority of the nomination committee must be comprised of outside directors and the compensation committee must be comprised entirely of outside directors.
- The directors must periodically participate in internal and external training programs that are organized to enhance their roles as director. Especially, the newly appointed directors attend an orientation program offered by an independent, external institution that specializes in corporate governance.
- The activities of an outside director should be evaluated fairly for determining remuneration and reappointment of the director.

Audit Systems

- Audits should be performed by individuals who are independent from the management and controlling shareholders of the corporate being audited and are knowledgeable in auditing.
- The Board of listed corporations, government-invested institutions and financial institutions should establish an audit committee. A corporation that establishes an audit committee need not have the auditor.
- An audit committee must be comprised of at least three board members, who preferably are outside directors, or two thirds, including the chair, of the committee must be outside directors. All members of the committee should have basic knowledge in auditing and at least one member must have a professional knowledge in auditing.
- In order for the audit committee to effectively fulfill its functions, the appropriate authority and status must be vested in the committee.
- The functions of the audit committee or auditor should include: to audit the business conduct of the directors and management; audit the soundness and reasonableness of financial transactions; examine appropriateness of financial reporting processes and accuracy of financial reports; review the adequacy of major accounting standards; evaluate the internal control systems.
- The audit committee should hold meetings at least once each quarter, and if need arises, may allow the attendance of management, financial officers, head of an internal audit unit or external auditor.

Stakeholders

- Rights of stakeholders stipulated in the laws and contracts should be protected, and stakeholders should hold appropriate means of redressing infringement of rights.
- Companies should observe creditor protection procedures concerning matters, such as mergers, capital decrease and split mergers, which greatly affect the position of creditors
- Companies should make every effort to maintain and improve the labor conditions by faithfully observing labor-related statutes
- Companies should not be negligent in its social responsibilities, such as consumer protection and environmental protection.
- The form and level of employee participation in corporate governance should be determined in accordance with the degree of contribution that the employee participation makes to sound corporate
- The corporation must, within the legal boundaries, make available to stakeholders information necessary for protecting their rights; and the stakeholders should be able to have access to relevant information.

Monitoring Management by the Market

- Corporate takeovers should be carried out through a transparent and fair procedure in a manner that does not impair the corporate value.
- In case of significant structural change such as merger or transfer of business, etc., a corporation must make it possible for the shareholders, who oppose such change, to exercise their claim for stock purchase at a fair price which reflects the real share value.
- Companies should actively disclose the matters of material importance to the decision-making of shareholder, creditors and other stakeholder.
- The annual report should include information on the following matters: business goals and strategies; financial condition and business performance; cross-shareholdings; business climate and risk factors; details of transactions with the largest shareholders; audit opinions of the external auditors and appraisals of credit rating agencies and others; accounting standards or accounting estimates that have significant effect on investment decisions; and details of unfaithful disclosures and sanctions thereof
- In the annual report, a public corporation shall explain the differences between its corporate governance and this Code, and the reasons for such; any plans to make future changes shall also be explained. Listed corporations must describe the differences between the existing corporate governance and this Code and the reasons thereof, as well as the planned enhancements and changes, if there are any, in their annual reports.
- Companies must make an appropriate disclosure of the forecast on future business performance and financial standing.
- A detailed disclosure should be made about the controlling shareholder, including his/her equity holding status and any changes thereof, his/her position within the company and his/her transactions with the company.

- The Chief Executive Officer and Chief Financial Officer of a listed or registered company must certify the accuracy and completeness of the financial report and must certify the facts that the financial report states all important information required to be covered and all statements are accurate.
- Companies must formulate business ethics and disclose thereof.

(Source: Code of Best Practices for Corporate Governance, 2003. Committee on Corporate Governance)

5.7 Challenges of Corporate Governance in Korea

The reforms initiated after the crisis of 1997 seemingly moved the governance system of Korea, a family-based *chaebols* dominated model towards the Anglo-American system.

The reforms were initiated by two aspects; firstly to destroy the traditional characteristics of *chaebol*, and secondly to build an Anglo-American corporate governance system. Through forcible *chaebol* reform by the government, accountability, transparency and financial health in the chaebol were attempted to be improved. *Chaebols* tried to resist mandated reforms, especially those regarding independent directors. Corporate chiefs argued that there was an insufficient pool of independent directors with managerial experience. In response to the government mandates for independent director majorities, many firms simply decreased the size of their boards and many other filled the boards with their friends and acquiesce.

Pressure from the government and financial markets, as well as changes in the competitive environment, however, did force *chaebols* to rethink their corporate governance. Samsung, for example, increased its number of independent directors, and initiated an active shareholder relations program, while the LG Group reconfigured itself into a holding company form.

The most important issue is whether the outside directors actually have adequate power to monitor the absolute control by the owners. Though it is legally required of public corporations to fill half their boards with outside directors, current regulations do not draw a clear distinction between an "outside" versus an "independent" director. As a result, *chaebols* can still fill their boardrooms with what are essentially management allies. The reports show that outside directors do not yet play a significant role in the governance of firms. Although the responsibilities and incentives for outside directors are quite well established, outside directors have been lacking in their responsibilities and corresponding activities to improve corporate transparency. Outside directors have tended not to attend regular board meetings and often have entrusted their voting rights to the executive directors who effectively appointed them.

The Korean Capital markets are still relatively passive in corporate governance. Although there has been more active investor engagement on some corporate governance issues that has been aided by shareholders activist groups such as People's Solidarity for Participatory Democracy, participation in general by domestic investors is limited. Except for a few, foreign investors are

too widely dispersed to play effectively the role of active agents. The level of foreign direct investment is still relatively low in Korea, and this limit furthers another form of corporate governance pressure.

Additionally, the ambiguous Korean regulatory climate and poor enforcement regime remain road blocks. Many efforts need to be made to tighten corporate governance rules. The policies need to be continuously evolved to further enhancing the role of the market and in the use of market-based methods to determine how corporations are monitored and governed and how financial difficulties are resolved.

The challenge facing corporate governance in Korea is to harmonise the traditional Korean system of *chaebols* with the Anglo-American system of corporate governance to acquire global competitiveness and attract foreign capital.

Case of Corporate Failure in Korea- Daewoo Group

Daewoo Group was a major South Korean *chaebol* founded in 1967 by Kim Woo-Jung. In 1997, it was the second largest conglomerate in Korea after Hyundai Group with over 320,000 employees in 500 domestic and foreign companies that operated in over 110 countries.

Initially, Daewoo concentrated on labor-intensive clothing and textile industries that provided high profit margins. Government policy played a major role in steady rise of Daewoo. The Korean Government provided massive subsidies, unlimited cheap credit, and protection against foreign competition. Gradually it played a major role in Korea's economic success. Under Kim's guidance, by 1996, Daewoo became the world's largest transnational entity among developing countries, surpassing such companies as Xerox, Amoco, Volvo, Fujitsu and Glaxo Wellcome. The group excelled at acquiring distressed companies, mostly from the government and then turning them around. In 1976, for instance, Daewoo assumed control over Hankook Machinery Ltd., a manufacturer of industrial machinery, rolling stock and diesel engines that had not shown a profit for thirty-eight years. Senior executives had opposed the acquisition, but Woo Choong Kim's prevailed upon them.[66] After changing its name to Daewoo Heavy Industries, the company started generating profits in its first year itself. Daewoo's mode of acquisition, turn around and expansion became a trademark of the conglomerate.

In 1978, Daewoo entered into the automobile industry through a 50 percent acquisition of Saehan Motor in a joint venture with GM Korea. The company sought growth and market share instead of focusing on profitability and research and development. After first buying out GM's remaining 50 percent stake in 1991, the conglomerate also entered into joint ventures with a series of foreign automobile companies to enter into East European and Asian markets including India. Daewoo was ranked as the seventh largest car exporter and the sixth largest car

[66]Aguilar & Cho.

manufacturer in the world. Throughout this period, Daewoo experienced great success at turning around faltering companies in Korea. The Group also produced consumer electronics, computers, and telecommunication and construction equipment.

The Downfall

Daewoo strategy of expansion was very aggressive and went on unchecked for years. The Korean Government supported the group even when it faced financial difficulties in 1980s. However, Daewoo continued to engage in investment decisions which often were based on unrealistic sales and profit projections. This ultimately resulted into poor earnings, particularly in the latter half of the 1990s.

The collapse of Daewoo actually began with the Asian crisis of 1997. The unprecedented crisis led to devaluation of the currency, flight of capital, downgrading of credit rating and drastically cut the credit available from the government to *chaebols.* By the 1990s, Daewoo Group was heavily leveraged, major markets were stagnant, expenditures on R&D were increasing, labor unrest was continuing, and government policy was turning against the company. The rating agency downgraded the rating to lowest possible of Junk Category.

The company, instead of selling non-core assets to tide over the difficult times, borrowed from any and every sources often at abnomicaly high rates. The Financial Supervisory Commission of Korea launched an investigation into suspected accounting fraud.

Eventually, by August 1999, the company was forced to be declared bankrupt. There were about 20 divisions under the Daewoo Group, some of which survived as independent companies.

After hiding as a fugitive overseas for over six years, Daewoo's chairman, Woo Choong Kim, returned to Korea in June 2005 to face criminal charges. In 2006, he was sentenced to eight and a half years in prison.

The collapse caused billions of dollars in losses for both South Korean banks and the government. The bankruptcy of Daewoo was not only a financial crisis, but also a political one, and it came as a shock to the country because of the sheer importance of *chaebols* in the national economy. It shook the persistent belief that Daewoo and other Korean conglomerates were "too big to fail".

Causes and Corporate Governance Issues

Debt Ridden Financial Structure

Daewoo's financial structure precariously relied upon debt. While debt-to-equity ratios for *chaebol* exceeded 400 percent, Daewoo surpassed everyone in its over-reliance on debt. As early

as 1988, with over $11.2 billion in borrowings, Daewoo stood as Korea's most indebted conglomerate.[67] Its debt gearing allegedly reached as high as 2,000 percent.[68]

Distorted Ownership Structure

Chairman Kim was able to control the conglomerate through a distorted yet tenuous ownership structure. In April 1997, for example, Kim and his family members, as controlling shareholders, only owned on average 6.1% of the shares in the major companies within the Daewoo Group.[69] Daewoo companies apparently did not seek equity financing due to concerns that this might dilute Kim's weak ownership position.[70] Kim maintained control through affiliated companies that on average cross-owned 31.2% of each other's shares and treasury shares that accounted for an additional 1%. Combined with his family ownership, he then could control on average 38.3% of the shares.[71]

Another notable feature was that the de facto holding company, the Daewoo Corp., was not the profit center of the conglomerate.[72] Daewoo Corp. primarily acted as a trading and financial company for products and services. In difficult times, therefore, it did not have capacity to provide financial support to weaker affiliates.

Weak Internal Corporate Governance

Weak internal corporate governance in particular was a common feature for many conglomerates leading up to the financial crisis. Internal corporate governance structures established under corporate law did not function to check controlling shareholder mismanagement. Representative directors, boards, statutory auditors and shareholders alike did not act as effective monitors. Kim's dominance of internal corporate governance fell far short of established global standards.

The internal supervisory structure also remained weak because at the time companies did not distinguish between directors and officers and had no outside directors. A more serious problem was that directors and auditors were not answerable to non-controlling shareholders or other stakeholders in any meaningful way and did not understand their obligations. Shareholder litigation, particularly derivative actions, did not exist until 1997.[73]

---

[67]Mark Clifford, *Under-Powered Performer*, FAR E. ECON. REV., Dec. 8. 1988

[68] Lee.

[69]MONTHLY CHOSUN, May 1985
[70] Lee,
[71]. KIM
[72] Lee

[73] Kim

As with most *chaebol* heads, Daewoo's founder and controlling shareholder, Woo Choong Kim, operated the conglomerate with total command, unchecked and unsupervised. He pursued a policy of expansion through acquisitions too aggressively based on untenable revenue projections. This policy was continued in the crucial period also when the revenues fell considerably.

Fundamentally, Kim failed to follow basic legal and managerial principles such as accounting, internal controls and financial discipline, placing too much emphasis upon generating sales and marketing. Corporate governance was unobserved; warning ignored and business was expanded through unprecedented accounting and loan fraud.

Daewoo's shareholders passivity is also to be blamed for the failure. The shareholders did not raise questions, request information, attend shareholders' meetings, engage in litigation, or meet with management. Curiously, foreign institutional investors with considerable equity positions also remained complacent bystanders. Despite their sophistication, they neglected governance-related action like everyone else. They did not seek board representation, accountability or transparency and failed to act as diligent monitors to curb fraud.

References

Aguilera, L. R and Ruth V. (2012).*Corporate Governance in Emerging Markets.*

Aguilera, Ruth V. and Gregory Jackson (2010)Comparative and International Corporate Governance,*The Academy of Management***,** Volume 4(1)

Byung Min, G. U. (2011). Corporate governance reforms in Korea| East Asia Forum. Retrieved from East Asia Forum: www.eastasiaforum.org/

Chang, S. J. (2003). Ownership structure, expropriation and performance of group-affiliated companies in Korea. *Academy of Management Journal,46*, 238–253

Chang, S. J., and J. Hong (2000), 'Economic Performance of Group-affiliated Companies in Korea: Intragroup Resource Sharing and Internal Business Transaction', *Academy of Management Journal*, **43**, 429–48.

Claessens**,** S and JPH Fan (2002) 'Corporate Governance in Asia: A Survey' *International Review of Finance*

Claessens, S. (2008). Korea's Economy. Korea Economic Institute and Korea Institute for International Economic Policy.

Clifford, Mark (1988), Under-Powered Performer, *FAR Eastern Economic Review*, December 8.

Jung, KT and Chung, HS (2002), 'Corporate Governance in Korea',*International Financial Law Review*.

Governance, C. o. (2003). Code of Best Practices for Corporate Governance

Jang, H. and Kim, J (2002), 'Nascent Stages of Corporate Governance in an Emerging Market: Regulatory Change, Shareholder Activism and Samsung Electronics' *Corporate Governance: An International Review* Vol 10(2).

Kang, M. H. (1999), 'Chaebol Reformation of corporate governance in Korea', *Korean Economic Studies*, 3: 113-151. (original in Korean)

Kim, E. Han and Kim, Woochan (2007) 'Corporate Governance in Korea: A Decade after the Financial Crisis',*U of Texas Law, Law and Econ Research Paper No. 123*

Kim, B and I Lee (2003) **'**Agency problems and performance of Korean companies during the Asian financial crisis: Chaebol vs. non-chaebol firms' *Pacific-Basin Finance Journal***,** Elsevier

Kim H. J. (2009) 'Inter and Intra-leverage Analyses for Large Firms in the United States and Korea', *Journal of Asia-Pacific Business*, 10(1), 34-64

Kim, D. W. (2003), 'Interlocking ownership in the Korean chaebol'*, Corporate Governance: An International Review*, 11(2): 132-142.

OECD (2014) *Science Technology and Industry Outlook*

http://www.bloomberg.com/slideshow/2014-01-22/30-most-innovative-countries.html#slide32
https://www.cia.gov/library/publications/the-world-factbook/geos/ks.html

OECD (1999) Address by Oh-Seok Hyun at Conference on "Corporate Governance in Asia- A Comparative Perspective"

6

Corporate Governance in Singapore

6.1 Country Analysis

Singapore founded as a British trading colony in 1819, is a major international transportation hub in Asia supported by its excellent financial infrastructure and pro-business environment. Singapore has a highly developed and successful free-market economy. It enjoys a remarkably open and corruption-free environment, stable prices, and a per capita GDP higher than that of most developed countries. The economy depends heavily on exports, particularly in consumer electronics, information technology products, pharmaceuticals, and on a growing financial services sector. Singapore has attracted major investments in pharmaceuticals and medical technology production and is continuing efforts to establish the country as Southeast Asia's financial and high-tech hub[74].

6.2 Corporate Governance Framework in Singapore

Corporate governance system in Singapore is based on the Anglo-American model encompassing features such as single-tier board of directors, board committees, capital market controls, protection of investors and creditors and prominent role of shareholders. However, owing to small size of the capital market[75] and closely-held shareholding by few individuals and families including the Government of Singapore, the global corporate governance standards have been adopted to the varying sizes and shareholdings of the companies.

The regulatory framework in Singapore contains mandatory rules laid down by the Companies Act, Securities and Futures Act and the listing rules of the Singapore Exchange Securities Trading Limited (SGX) for listed companies, and best practice recommendations in the form of code of corporate governance (code) issued by Monetary Authority of Singapore (MAS).

Uniquely, Singapore Exchange Securities Trading Limited (SGX) is both a listed securities exchange and a regulator. The regulatory function of the SGX is under the control and supervision of the Monetary Authority of Singapore (MAS). While both Singapore-incorporated and foreign-incorporated corporations are listed on SGX, Singapore-incorporated companies are also governed by the Companies Act of Singapore.

Of the voluntary organisations active in Singapore are the Securities Investor's Association (SIAS) which represents minority retail investors and Singapore Institute of Director (SID) which is national association of company directors. In practice, SIAS and SID are often

[74]https://www.cia.gov/library/publications/the-world-factbook/geos/sn.html

[75] There were only 776 listed companies on the Singapore Stock Exchange in 2012.

consulted for their views before implementation of key regulatory changes affecting investors and directors[76].

6.3 Ownership Structure

Corporate governance in Singapore is largely government and family-based, as there is high ownership concentration of corporations in Singapore amongst certain family shareholders and the government. An important feature of the Singapore corporate governance is the presence of "government-linked companies" (GLCs), that is, companies that are fully or partially owned by the government. Although in the wake of privatization during the last three decades, the shareholding of the government in Singapore companies has reduced, the 'deeply entrenched family ownership structure' of Singapore corporations remains to some extent, which makes it hard to impose global corporate governance standards on such corporations.[77]

The board structure of listed companies in Singapore is that of a major shareholder which is an individual or a family who serves as the CEO of the company and also the board chairperson. The typical problem of principal-principal i.e. majority shareholders versus minority shareholders arises wherein dominant shareholder running the company may have objectives different from the minority shareholders. To resolve this problem, independent directors are required to form a sizable proportion on the boards of companies primarily to protect the interest of minority shareholders. The effectiveness of such directors is a suspect in Singapore like most other Asian countries because the majority shareholders exert their influence on independent directors by having a significant say in the matter of their appointment and continuation. The lack of independence of independent directors and the concentrated shareholding, combined with the 'well-known unwillingness of Singaporeans to buck the system', means there may be little restraint on the dominant shareholder who wields a considerable influence on the management. Independent directors are fearful of reprisal and are afraid of not having their appointment renewed by the executive board, so much so it has been said that in reality strong minded independent directors who exercise their intended role are a rarity[78].

6.4 Board Structure

Singapore essentially follows the single-tier board structure prevalent in countries like United States and UK. It is characterized by single board comprising of both executive directors and non-executive directors all of whom are in usual course nominated and appointed by shareholders. Though single tier board structure facilitates non-reliance of the non-executive

---

[76] Annabelle Yip and Joy Tan (2013) In *The Corporate Governance Review* Ed Willem JL Calkoen, Law Business Research Ltd, UK

[77]http://www.sias.org.sg/SingaporeInvestor/fa-davidgeraldMarch.html at 23 September 2010.

[78]Securities Investors' Association *(2008) The Independent Director– Myth or Reality?*

members on the executive board for information which they have a direct access to as a result of being on the board but under the one-tier board structure, it is noted that one of the structural problems in Singapore is the practice of combining the positions of both the chief executive officer and the chairman and thereby concentration of power. Although the Singapore Code mandates separation of the two positions, the Code does not have the force of law and provides flexibility to adopt their own approach to corporate governance centering around the main corporate governance principles.

6.5 Code of Corporate Governance

The code of corporate governance in Singapore was first implemented in March 2001, and then revised in 2005. With effect from September 2007, the code came under the purview of MAS and SGX. This code was further revised in May 2012 which was implemented from November 2012. The code like the code in the UK is based on "comply or explain" principle wherein compliance with code is not mandatory, companies are required to disclose any deviation from code provision and to provide an appropriate explanation for such deviation in annual report.

1. **BOARD COMPOSITION AND GUIDANCE**

Principle:

There should be a strong and independent element on the Board, which is able to exercise objective judgment on corporate affairs independently, in particular, from Management and 10% shareholders. No individual or small group of individuals should be allowed to dominate the Board's decision making.

Guidelines:

1.1 There should be a strong and independent element on the Board, with independent directors making up at least one-third of the Board.

1.2 The independent directors should make up at least half of the Board where:

(a) the Chairman of the Board (the "Chairman") and the chief executive officer (or equivalent) (the "CEO") is the same person;

(b) the Chairman and the CEO are immediate family members;

(c) the Chairman is part of the management team; or

(d) the Chairman is not an independent director.

1.3 The independence of any director who has served on the Board beyond nine years from the date of his first appointment should be subject to particularly rigorous review. In

doing so, the Board should also take into account the need for progressive refreshing of the Board. The Board should also explain why any such director should be considered independent.

1.4 To facilitate a more effective check on Management, non-executive directors are encouraged to meet regularly without the presence of Management.

2. CHAIRMAN AND CHIEF EXECUTIVE OFFICER

Principle:

There should be a clear division of responsibilities between the leadership of the Board and the executives responsible for managing the company's business. No one individual should represent a considerable concentration of power.

Guidelines:

2.1 The Chairman and the CEO should in principle be separate persons, to ensure an appropriate balance of power, increased accountability and greater capacity of the Board for independent decision making. The division of responsibilities between the Chairman and the CEO should be clearly established, set out in writing and agreed by the Board. In addition, the Board should disclose the relationship between the Chairman and the CEO if they are immediate family members.

2.2 Every company should appoint an independent director to be the lead independent director where:

(a) the Chairman and the CEO is the same person;

(b) the Chairman and the CEO are immediate family members;

(c) the Chairman is part of the management team; or

(d) the Chairman is not an independent director.

The lead independent director (if appointed) should be available to shareholders where they have concerns and for which contact through the normal channels of the Chairman, the CEO or the chief financial officer (or equivalent) (the "CFO") has failed to resolve or is inappropriate.

2.3 Led by the lead independent director, the independent directors should meet periodically without the presence of the other directors, and the lead independent director should provide feedback to the Chairman after such meetings.

3. BOARD MEMBERSHIP

Principle:

There should be a formal and transparent process for the appointment and reappointment of directors to the Board.

Guidelines:

3.1 The Board should establish a NC to make recommendations to the Board on all board appointments, with written terms of reference which clearly set out its authority and duties. The NC should comprise at least three directors, the majority of whom, including the NC Chairman, should be independent. The lead independent director, if any, should be a member of the NC. The Board should disclose in the company's Annual Report the names of the members of the NC and the key terms of reference of the NC, explaining its role and the authority delegated to it by the Board.

3.2 The NC should make recommendations to the Board on relevant matters relating to:

(a) the review of board succession plans for directors, in particular, the Chairman and for the CEO;

(b) the development of a process for evaluation of the performance of the Board, its board committees and directors;

(c) the review of training and professional development programs for the Board; and

(d) the appointment and re-appointment of directors (including alternate directors, if applicable).

Important issues to be considered as part of the process for the selection, appointment and re-appointment of directors include composition and progressive renewal of the Board and each director's competencies, commitment, contribution and performance (e.g. attendance, preparedness, participation and candour) including, if applicable, as an independent director.

All directors should be required to submit themselves for re-nomination and reappointment at regular intervals and at least once every three years.

4. MULTIPLE BOARD REPRESENTATIONS:

When a director has multiple board representations, he must ensure that sufficient time and attention is given to the affairs of each company. The NC should decide if a director is able to and has been adequately carrying out his duties as a director of the company, taking into consideration the director's number of listed company board representations and other principal Commitments.

5. ALTERNATE DIRECTORS:

Boards should generally avoid approving the appointment of alternate directors. Alternate directors should only be appointed for limited periods in exceptional cases such as when a director has a medical emergency. If an alternate director is appointed, the alternate director should be familiar with the company affairs, and be appropriately qualified. If a person is proposed to be appointed as an alternate director to an independent director, the NC and the Board should review and conclude that the person would similarly qualify as an independent director, before his appointment as an alternate director. Alternate directors bear all the duties and responsibilities of a director.

A description of the process for the selection, appointment and re-appointment of directors to the Board should be disclosed in the company's Annual Report. This should include disclosure on the search and nomination process.

Key information regarding directors, such as academic and professional qualifications, shareholding in the company and its related corporations, board committees served on (as a member or chairman), date of first appointment as a director, date of last re-appointment as a director, directorships or chairmanships both present and those held over the preceding three years in other listed companies, and other principal commitments, should be disclosed in the company's Annual Report. In addition, the company's annual disclosure on corporate governance should indicate which directors are executive, nonexecutive or considered by the NC to be independent. The names of the directors submitted for appointment or re-appointment should also be accompanied by details and information to enable shareholders to make informed decisions. Such information, which should also accompany the relevant resolution, would include:

(a) any relationships including immediate family relationships between the candidate and the directors, the company or its 10% shareholders;

(b) a separate list of all current directorships in other listed companies; and

(c) details of other principal commitments.

6. BOARD PERFORMANCE

Principle:

There should be a formal annual assessment of the effectiveness of the Board as a whole and its board committees and the contribution by each director to the effectiveness of the Board.

Guidelines:

6.1 Every Board should implement a process to be carried out by the NC for assessing the effectiveness of the Board as a whole and its board committees and for assessing the

contribution by the Chairman and each individual director to the effectiveness of the Board. The Board should state in the company's Annual Report how the assessment of the Board, its board committees and each director has been conducted. If an external facilitator has been used, the Board should disclose in the company's Annual Report whether the external facilitator has any other connection with the company or any of its directors. This assessment process should be disclosed in the company's Annual Report.

7. ACCESS TO INFORMATION

Principle:

In order to fulfil their responsibilities, directors should be provided with complete, adequate and timely information prior to board meetings and on an on-going basis so as to enable them to make informed decisions to discharge their duties and responsibilities.

Guidelines:

7.1 Management has an obligation to supply the Board with complete, adequate information in a timely manner. Relying purely on what is volunteered by Management is unlikely to be enough in all circumstances and further enquiries may be required if the particular director is to fulfil his duties properly. Hence, the Board should have separate and independent access to Management.

Directors are entitled to request from Management and should be provided with such additional information as needed to make informed decisions. Management shall provide the same in a timely manner.

7.2 Information provided should include board papers and related materials, background or explanatory information relating to matters to be brought before the Board, and copies of disclosure documents, budgets, forecasts and monthly internal financial statements. In respect of budgets, any material variance between the projections and actual results should also be disclosed and explained.

8. REMUNERATION MATTERS

PROCEDURES FOR DEVELOPING REMUNERATION POLICIES

Principle:

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his own remuneration.

Guidelines:

8.1 The Board should establish a Remuneration Committee ("RC") with written terms of reference which clearly set out its authority and duties.
8.2 The RC should comprise at least three directors, the majority of whom, including the RC Chairman, should be independent.
8.3 All of the members of the RC should be non-executive directors. This is to minimise the risk of any potential conflict of interest. The Board should disclose in the company's Annual Report the names of the members of the RC and the key terms of reference of the RC, explaining its role and the authority delegated to it by the Board.
8.4 The RC should review and recommend to the Board a general framework of remuneration for the Board and key management personnel(CEO and other persons having authority and responsibility for planning, directing and controlling the activities of the company).
8.5 The RC should also review and recommend to the Board the specific remuneration packages for each director as well as for the key management personnel.
8.6 The RC should cover all aspects of remuneration, including but not limited to director's fees, salaries, allowances, bonuses, options, share-based incentives and awards, and benefits in kind.
8.7 The company should also disclose the names and firms of the remuneration consultants in the annual remuneration report, and include a statement on whether the remuneration consultants have any such relationships with the company.

9. LEVEL AND MIX OF REMUNERATION

Principle:

The level and structure of remuneration should be aligned with the long-term interest and risk policies of the company, and should be appropriate to attract, retain and motivate (a) the directors to provide good stewardship of the company, and (b) key management personnel to successfully manage the company. However, companies should avoid paying more than is necessary for this purpose:

9.1 Non-executive directors should not be overcompensated to the extent that their independence may be compromised.
9.2 The RC should also consider implementing schemes to encourage non-executive directors to hold shares in the company so as to better align the interests of such non-executive directors with the interests of shareholders.
9.3 Companies are encouraged to consider the use of contractual provisions to allow the company to reclaim incentive components of remuneration from executive directors and key management personnel in exceptional circumstances of misstatement of financial results, or of misconduct resulting in financial loss to the company.

10. DISCLOSURE ON REMUNERATION

Principle:

Every company should provide clear disclosure of its remuneration policies, level and mix of remuneration, and the procedure for setting remuneration, in the company's Annual Report. It should provide disclosure in relation to its remuneration policies to enable investors to understand the link between remuneration paid to directors and key management personnel, and performance.

Guidelines:

10.1 The company should report to the shareholders each year on the remuneration of directors, the CEO and at least the top five key management personnel (who are not also directors or the CEO) of the company. This annual remuneration report should form part of, or be annexed to the company's annual report of its directors. It should be the main means through which the company reports to shareholders on remuneration matters.

10.2 The annual remuneration report should include the aggregate amount of any termination, retirement and post-employment benefits that may be granted to directors, the CEO and the top five key management personnel (who are not directors or the CEO).

11. REMUNERATION MATTERS

11.1 The company should fully disclose the remuneration of each individual director and the CEO on a named basis. For administrative convenience, the company may round off the disclosed figures to the nearest thousand dollar.

11.2 There should be a breakdown (in percentage or dollar terms) of each director's and the CEO's remuneration earned through base/fixed salary, variable or performance related income/bonuses, benefits in kind, stock options granted, share-based incentives and awards, and other long-term incentives.

11.3 The company should name and disclose the remuneration of at least the top five key management personnel (who are not directors or the CEO) in bands of S$250,000. Companies need only show the applicable bands.

11.4 There should be a breakdown (in percentage or dollar terms) of each key management personnel's remuneration earned through base/fixed salary, variable or performance-related income/bonuses, benefits in kind, stock options granted, share-based incentives and awards, and other long-term incentives.

11.5 In addition, the company should disclose in aggregate the total remuneration paid to the top five key management personnel (who are not directors or the CEO).As best practice, companies are also encouraged to fully disclose the remuneration of the said top five key management personnel.

11.6 For transparency, the annual remuneration report should disclose the details of the remuneration of employees who are immediate family members of a director or the CEO, and whose remuneration exceeds S$50,000 during the year. This will be done on a named basis with clear indication of the employee's relationship with the relevant director or the CEO. Disclosure of remuneration should be in incremental bands of S$50,000. The company need to only show the applicable bands.

11.7 The annual remuneration report should also contain details of employee share schemes to enable their shareholders to assess the benefits and potential cost to the companies. The important terms of the share schemes should be disclosed, including the potential size of grants, methodology of valuing stock options, exercise price of options that were granted as well as outstanding, whether the exercise price was at the market or otherwise on the date of grant, market price on the date of exercise, the vesting schedule, and the justifications for the terms adopted.

12. ACCOUNTABILITY AND AUDIT

12.1 ACCOUNTABILITY

Principle:

The Board should present a balanced and understandable assessment of the company's performance, position and prospects.

Guidelines:

12.1.1 The Board's responsibility to provide a balanced and understandable assessment of the company's performance, position and prospects extends to interim and other price sensitive public reports, and reports to regulators (if required).

12.1.2 The Board should take adequate steps to ensure compliance with legislative and regulatory requirements, including requirements under the listing rules of the securities exchange, for instance, by establishing written policies where appropriate.

12.1.3 Management should provide all members of the Board with management accounts and such explanation and information on a monthly basis and as the Board may require from time to time to enable the Board to make a balanced and informed assessment of the company's performance, position and prospects.

12.2 AUDIT COMMITTEE

Principle:

The Board should establish an Audit Committee ("AC") with written terms of reference which clearly set out its authority and duties.

COMPOSITION:

12.2.1 The AC should comprise at least three directors, the majority of whom, including the AC Chairman, should be independent.

All of the members of the AC should be non-executive directors. The Board should disclose in the company's Annual Report the names of the members of the AC and the key terms of reference of the AC, explaining its role and the authority delegated to it by the Board.

12.2.2 At least two members, including the AC Chairman, should have recent and relevant accounting or related financial management expertise or experience, as the Board interprets such qualification in its business judgement.

12.2.3 A former partner or director of the company's existing auditing firm or auditing corporation should not act as a member of the company's AC:

(a) within a period of 12 months commencing on the date of his ceasing to be a partner of the auditing firm or director of the auditing corporation; and in any case

(b) for as long as he has any financial interest in the auditing firm or auditing corporation.

DUTIES:

12.2.4 The duties of the AC should include:

(a) reviewing the significant financial reporting issues and judgements so as to ensure the integrity of the financial statements of the company and any announcements relating to the company's financial performance;

(b) reviewing and reporting to the Board at least annually the adequacy and effectiveness of the company's internal controls, including financial, operational, compliance and information technology controls (such review can be carried out internally or with the assistance of any competent third parties);

(c) reviewing the effectiveness of the company's internal audit function;

(d) reviewing the scope and results of the external audit, and the independence and objectivity of the external auditors; and

(e) making recommendations to the Board on the proposals to the shareholders on the appointment, re-appointment and removal of the external

auditors, and approving the remuneration and terms of engagement of the external auditors.

12.2.5 The AC should review the independence of the external auditors annually and should state

(a) the aggregate amount of fees paid to the external auditors for that financial year, and

(b) a breakdown of the fees paid in total for audit and non-audit services respectively, or an appropriate negative statement,

in the company's Annual Report. Where the external auditors also supply a substantial volume of non-audit services to the company, the AC should keep the nature and extent of such services under review, seeking to maintain objectivity.

12.2.6 The AC's objective should be to ensure that arrangements are in place for such concerns to be raised and independently investigated, and for appropriate follow-up action to be taken. The existence of a whistle-blowing policy should be disclosed in the company's Annual Report, and procedures for raising such concerns should be publicly disclosed as appropriate.

12.2.7 The Board should disclose a summary of all the AC's activities in the company's Annual Report. The Board should also disclose in the company's Annual Report measures taken by the AC members to keep abreast of changes to accounting standards and issues which have a direct impact on financial statements.

MEETING:

12.2.8 The AC should meet

(a) with the external auditors, and

(b) with the internal auditors,

in each case without the presence of Management, at least annually.

13. RISK MANAGEMENT AND INTERNAL CONTROLS

Principle:

The Board is responsible for the governance of risk. The Board should ensure that Management maintains a sound system of risk management and internal controls to safeguard shareholders' interests and the company's assets, and should determine the nature and extent of the significant risks which the Board is willing to take in achieving its strategic objectives.

Guidelines:

13.1 The Board should determine the company's levels of risk tolerance and risk policies, and oversee Management in the design, implementation and monitoring of the risk management and internal control systems.

13.2 The Board should, at least annually, review the adequacy and effectiveness of the company's risk management and internal control systems, including financial, operational, compliance and information technology controls. Such review can be carried out internally or with the assistance of any competent third parties.

13.3 The Board should comment on the adequacy and effectiveness of the internal controls, including financial, operational, compliance and information technology controls, and risk management systems, in the company's Annual Report. The Board's commentary should include information needed by stakeholders to make an informed assessment of the company's internal control and risk management systems.

13.4 The Board should also comment in the company's Annual Report on whether it has received assurance from the CEO and the CFO:

(a) that the financial records have been properly maintained and the financial statements give a true and fair view of the company's operations and finances; and

(b) regarding the effectiveness of the company's risk management and internal control systems.

13.5 The Board may establish a separate board risk committee or otherwise assess appropriate means to assist it in carrying out its responsibility of overseeing the company's risk management framework and policies.

14. INTERNAL AUDIT

Principle:

The company should establish an effective internal audit function that is adequately resourced and independent of the activities it audits.

Guidelines:

14.1 The Internal Auditor's primary line of reporting should be to the AC Chairman although the Internal Auditor would also report administratively to the CEO.

14.2 The AC should ensure that the internal audit function is adequately resourced and has appropriate standing within the company. For the avoidance of doubt, the internal audit function can be in-house, outsourced to a reputable accounting/auditing firm or corporation, or performed by a major shareholder, holding company or controlling enterprise with an internal audit staff.

14.3 The internal audit function should be staffed with persons with the relevant qualifications and experience.

14.4 The Internal Auditor should carry out its function according to the standards set by nationally or internationally recognized professional bodies including the Standards for the Professional Practice of Internal Auditing set by The Institute of Internal Auditors.

14.5 The AC should, at least annually, review the adequacy and effectiveness of the internal audit function.

15. SHAREHOLDER RIGHTS

15.1 Companies should facilitate the exercise of ownership rights by all shareholders. In particular, shareholders have the right to be sufficiently informed of changes in the company or its business which would be likely to materially affect the price or value of the company's shares.

15.2 Companies should ensure that shareholders have the opportunity to participate effectively in and vote at general meetings of shareholders. Shareholders should be informed of the rules, including voting procedures, that govern general meetings of shareholders.

15.3 Companies should allow corporations which provide nominee or custodial services to appoint more than two proxies so that shareholders who hold shares through such corporations can attend and participate in general meetings as proxies.

16. COMMUNICATION WITH SHAREHOLDERS

Principle:

Companies should actively engage their shareholders and put in place an investor relations policy to promote regular, effective and fair communication with shareholders.

Guidelines:

16.1 Companies should disclose information on a timely basis through SGXNET and other information channels, including a well-maintained and updated corporate website. Where there is inadvertent disclosure made to a select group, companies should make the same disclosure publicly to all others as promptly as possible

16.2 The Board should establish and maintain regular dialogue with shareholders, to gather views or inputs, and address shareholders' concerns.

16.3 The Board should state in the company's Annual Report the steps it has taken to solicit and understand the views of the shareholders e.g. through analyst briefings, investor roadshows or Investors' Day briefings.

16.4 Companies are encouraged to have a policy on payment of dividends and should communicate it to shareholders. Where dividends are not paid, companies should disclose their reasons.

17. CONDUCT OF SHAREHOLDER MEETINGS

Principle:

Companies should encourage greater shareholder participation at general meetings of shareholders, and allow shareholders the opportunity to communicate their views on various matters affecting the company.

Guidelines:

17.1 Shareholders should have the opportunity to participate effectively in and to vote at general meetings of shareholders. Companies should make the appropriate provisions in their Articles of Association (or other constitutive documents) to allow for absentia voting at general meetings of shareholders.

17.2 There should be separate resolutions at general meetings on each substantially separate issue. Companies should avoid "bundling" resolutions unless the resolutions are interdependent and linked so as to form one significant proposal.

17.3 All directors should attend general meetings of shareholders. In particular, the Chairman of the Board and the respective Chairman of the AC, NC and RC should be present and available to address shareholders' queries at these meetings. The external auditors should also be present to address shareholders' queries about the conduct of audit and the preparation and content of the auditors' report.

17.4 Companies should prepare minutes of general meetings that include substantial and relevant comments or queries from shareholders relating to the agenda of the meeting, and responses from the Board and Management, and to make these minutes available to shareholders upon their request.

17.5 Companies should put all resolutions to vote by poll and make an announcement of the detailed results showing the number of votes cast for and against each resolution and the respective percentages. Companies are encouraged to employ electronic polling.

18. DISCLOSURE OF CORPORATE GOVERNANCE ARRANGEMENTS

The Listing Manual requires listed companies to describe in their company's Annual Reports their corporate governance practices with specific reference to the principles of the Code, as well as disclose and explain any deviation from any guideline of the Code. Companies should make a positive confirmation at the start of the corporate governance section of the company's Annual Report that they have adhered to the principles and guidelines of the Code, or specify each area of non-compliance. Many of these guidelines are recommendations for companies to disclose their corporate governance arrangements. For ease of reference, the specific principles and guidelines in the Code with express disclosure requirements are set out below:

- Delegation of authority, by the Board to any board committee, to make decisions on certain board matters:
- The number of meetings of the Board and board committees held in the year, as well as the attendance of every board member at these meetings
- The type of material transactions that require board approval under guidelines
- The induction, orientation and training provided to new and existing directors
- The Board should identify in the company's Annual Report each director it considers to be independent. Where the Board considers a director to be independent in spite of the existence of a relationship as stated in the Code that would otherwise deem a director not to be independent, the nature of the director's relationship and the reasons for considering him as independent should be disclosed
- Where the Board considers an independent director, who has served on the Board for more than nine years from the date of his first appointment, to be independent, the reasons for considering him as independent should be disclosed.
- Relationship between the Chairman and the CEO where they are immediate family members
- Names of the members of the NC and the key terms of reference of the NC, explaining its role and the authority delegated to it by the Board
- The maximum number of listed company board representations which directors may hold should be disclosed
- Process for the selection, appointment and re-appointment of new directors to the Board, including the search and nomination process
- Key information regarding directors, including which directors are executive, non-executive or considered by the NC to be independent
- The Board should state in the company's Annual Report how assessment of the Board, its board committees and each director has been conducted. If an external facilitator has been used, the Board should disclose in the company's Annual Report whet her the external facilitator has any other connection with the company or any of its directors. This assessment process should be disclosed in the company's Annual Report
- Names of the members of the RC and the key terms of reference of the RC, explaining its role and the authority delegated to it by the Board
- Names and firms of the remuneration consultants (if any) should be disclosed in the annual remuneration report, including a statement on whether the remuneration consultants have any relationships with the company
- Clear disclosure of remuneration policies, level and mix of remuneration, and procedure for setting remuneration
- Remuneration of directors, the CEO and at least the top five key management personnel (who are not also directors or the CEO) of the company. The annual remuneration report should include the aggregate amount of any termination, retirement and

postemployment benefits that may be granted to directors, the CEO and the top five key management personnel (who are not directors or the CEO)

- Fully disclose the remuneration of each individual director and the CEO on a named basis. There will be a breakdown (in percentage or dollar terms) of each director's and the CEO's remuneration earned through base/fixed salary, variable or performance-related income/bonuses, benefits in kind, stock options granted, share-based incentives and awards, and other long-term incentives
- Name and disclose the remuneration of at least the top five key management personnel (who are not directors or the CEO) in bands of S$250,000. There will be a breakdown (in percentage or dollar terms) of each key management personnel's remuneration earned through base/fixed salary, variable or performance-related income/bonuses, benefits in kind, stock options granted, share-based incentives and awards, and other long-term incentives. In addition, the company should disclose in aggregate the total remuneration paid to the top five key management personnel (who are not directors or the CEO). As best practice, companies are also encouraged to fully disclose the remuneration of the said top five key management personnel
- Details of the remuneration of employees who are immediate family members of a director or the CEO, and whose remuneration exceeds S$50,000 during the year. This will be done on a named basis with clear indication of the employee's relationship with the relevant director or the CEO. Disclosure of remuneration should be in incremental bands of S$50,000.
- Details and important terms of employee share schemes

  For greater transparency, companies should disclose more information on the link between remuneration paid to the executive directors and key management personnel, and performance. The annual remuneration report should set out a description of performance conditions to which entitlement to short-term and long-term incentive schemes are subject, an explanation on why such performance conditions were chosen, and a statement of whether such performance conditions are met.
- The Board should comment on the adequacy and effectiveness of the internal controls, including financial, operational, compliance and information technology controls, and risk management systems. The commentary should include information needed by stakeholders to make an informed assessment of the company's internal control and risk management systems. The Board should also comment on whether it has received assurance from the CEO and the CFO: (a) that the financial records have been properly maintained and the financial statements give true and fair view of the company's operations and finances; and (b) regarding the effectiveness of the company's risk management and internal control systems.
- Names of the members of the AC and the key terms of reference of the AC, explaining its role and the authority delegated to it by the Board.

- Aggregate amount of fees paid to the external auditors for that financial year, and breakdown of fees paid in total for audit and non-audit services respectively, or an appropriate negative statement.
- The existence of a whistle-blowing policy should be disclosed in the company's Annual Report.
- Summary of the AC's activities and measures taken to keep abreast of changes to accounting standards and issues which have a direct impact on financial statements
- The steps the Board has taken to solicit and understand the views of the shareholders e.g. through analyst briefings, investor roadshows or Investors' Day briefings
- Where dividends are not paid, companies should disclose their reasons.

6.6 Concluding Remarks

Corporate governance in Singapore has successfully integrated the Anglo-American regulatory rules, structures and practices with the traditional Asian culture and eastern markets and opportunities. This is one of the key reasons of Singapore as an attractive destination of investment for international companies. In the corporate governance ranking of 11 countries conducted by the Asian Corporate Governance Association and Credit Lyonnais (CLSA), Singapore is ranked first in the year 2010. There are, however a few areas of concern which pose a challenge and a roadmap to the regulators and the public corporations.

Role of independent directors in Singapore is a contentious area. This arises primarily from the influence which dominant shareholders have in appointing them. The corporate governance code also does not preclude independence of independent directors from major shareholders. Similarly the Singapore Code requires one third of the board to comprise of independent directors different from the fifty percent requirement in the UK and other developed countries. The role of independent directors is still not defined clearly. Often the same three independent directors sit on all three board committees- audit committee, remuneration committee and nomination committee. This obscures the ability of directors to carry out its responsibilities effectively[79].

[79]KPMG Audit Committee Institute (2011) *Singapore's Corporate Governance Transformation: The Strategy to Get it Right,* Singapore

References

Annabelle Yip and Joy Tan (2013) In *The Corporate Governance Review* Ed Willem JL Calkoen, Law Business Research Ltd, UK

Calkoen, William J L (2012), The Code of Corporate Governance, *The Corporate Governance Review* 2 May

http://www.sias.org.sg/SingaporeInvestor/fa-davidgeraldMarch.html at 23 September 2010.

https://www.cia.gov/library/publications/the-world-factbook/geos/sn.html

Hui Yun Corinne Tan (2011) The One-Tier and Two-Tier Board Structures and Hybrids in Asia – Convergence and What Really Matters for Corporate Governance,

KPMG Audit Committee Institute (2011) *Singapore's Corporate Governance Transformed: The Strategy To Get It Right,* Singapore

Mak Yuen Teen, *Issues and Challenges in Corporate Governance in Asia and Implications for Internal Auditors*, Corporate Governance and Financial Reporting Centre, National University of Singapore and Regional Research Director (Asia Pacific), Watson Wyatt Worldwide

Phillip H. Phan and Toru Yoshikawa, *Corporate Governance in Singapore: Developments and Prognoses*. Rensselaer Polytechnic Institute;, Singapore Management University

7

Corporate Governance in the MENA Countries

7.1 Introduction

MENA is an abbreviation used for a group of 20 Middle East North African countries sharing similar geographical and cultural attributes. As per the World Bank, the MENA Region includes: Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Malta, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, United Arab Emirates, West Bank and Gaza, Yemen.

The region comprises of countries with diverse economic and natural resources, with rich countries like the Gulf countries as well as resource scarce countries like Yemen and Tunisia. The region has wide economic disparity, with about 23 percent of the 300 million people in the Middle East and North Africa living on less than $2 a day.

The region accounts for roughly 6% of the total population of the world. The economy of the region is mainly dependent upon the oil and petrochemicals. According to the Oil and Gas Journal (January 1, 2009), the MENA region has 60% of the world's oil reserves and about 45% of the Natural Gas reserves. The economic policies of the region have been characterized by a heavy reliance of state controlled business enterprises, along with a strong family based business ownership. The region faces an urgent need for economic reforms, both at legislative and infrastructure front.

The concept of corporate governance has been gaining popularity in the region in the recent past and an attempt has been made to take measures in this direction with the help of international organizations. As a result, the economic framework supporting the corporate governance practices are being updated with the view of achieving best practices and protecting the interest of all stakeholders. Following the financial market failures and global banking crisis in the last few years there has been a call for greater transparency and disclosure within the financial sector and corporate world in general. This has resulted in the proliferation of regulations on better corporate governance and risk management in most MENA countries.

In this section, the progress of corporate governance practices in this region is analysed. Although the discussion would cover the entire MENA region, a key focus would remain only the Asian countries of the MENA region namely Bahrain, Iran, Iraq, Jordon, Kuwait, Lebanon,

UAE, Oman, Qatar, Saudi Arabia, Syria and Yemen. The following text provides an overall picture of the MENA region in terms of various aspects of corporate governance.

7.2 Evolution of Corporate Governance

The majority of businesses in the MENA countries are state owned enterprises, family-owned firms and small and medium-sized enterprises. The corporate governance practices in the MENA region have gained importance only in the past decade as the corporations were initially averse to adopt corporate governance practices. But in the beginning of the 21st century, the concept of corporate governance gained popularity.

"Initial interest in corporate governance in the region was propelled by the drive to attract foreign investment and the increasing development of local capital markets. A second wave now appears to be forming and its results will depend largely on the capacity of national regulators to enforce existing corporate governance provisions."[80]

The initial wave of corporate governance was driven by growing need to attract global investors, especially by countries with scarce petrochemical resources with the view of fostering infrastructure development. As a result, the corporate governance initiatives were taken which involved issuance of various codes of corporate governance and setting up of corporate governance institutes. The OECD principles were taken as a basis for development of a majority of these codes. "Between 2005 and 2009, 11 corporate governance codes were introduced by national regulations, in addition to specialized guidance for state-owned enterprises, banks and family-owned companies"

In the regions, banks acted as a principal source of finance. But the corporate culture which was aversive to disclosures and transparent practices, acted as a roadblock. Gradually, over the years the corporate houses have realized the importance of disclosures and broader corporate governance practices leading to better practices and development of capital markets. The stock market crash of 2006 in the Gulf region, lead to a growing consciousness amongst regulators to make capital markets less prone to jitters and less-rumor driven.

The compliance of corporate governance codes was initially done on a voluntary basis. But with the passage of time, various measures have been taken to make them binding on business enterprises by including them into listing provisions. Measures have also been taken on the legislative and regulatory front, but still the framework in the MENA regions remains slack as compared to its international counterparts.

80 Koldertsova, Alissa (2008) *Private Sector Development in the Middle East and North Africa: Making Reforms Succeed.* OECD

The first wave of corporate governance in the region was certainly able to make its mark. The resistance of family-based enterprises to outside funds and disclosure aversive behavior has been the main roadblocks in the progress. Now there has been a change in focus with regulators shifting their focus by making the compliance of codes mandatory instead of voluntary.

The second wave of corporate governance reforms has been observed in the recent years. A shift of focus towards revision of codes, and a key emphasis on their implementation has led to an upsurge. Stock exchanges and market regulators are now growing more conscious towards this cause. Numerous conference and research works are being undertaken, especially by the National Institutes of Corporate Governance.

Thus, looking at the evolution of the concept in the region it could be said that international factors were the key drivers towards initiation of good corporate governance practices in the region. Over the years, it could be expected that better regulatory framework would be put into place to ensure best practices in the area. Over the years, the nations may even work upon the development of a common code for the entire region.

7.3 Specific Issues in Corporate Governance

Having taken an overview about the evolution of corporate governance practices, the upcoming section would aim at having a closer look at the various specific issues relating to corporate governance practices in the region.

As specified in the IFC-Hawkamah 2008 MENA wide Corporate Governance Survey, there are five elements of good corporate governance:

- Good board practices
- Control environment and processes
- Disclosure and transparency
- Shareholders' Right
- Commitment

Good Board Practices

Board of Directors form the basic pillar of corporate governance practices. The board sets the overall vision and strategic policies for the organization. They act as a trustee for the shareholders and hence a competent, independent and vigilant board is essential for successful implementation of corporate governance practices. Thus, every set of reforms must lay a key focus upon enhanced board practices in order to ensure the overall success in this direction.

Role of the board

The role of the board has always been very significant in terms of formulation of the overall strategy of the organization. The corporate governance codes across the MENA countries have

explicitly addressed the power and responsibilities of the board. Despite certain variation across countries in terms of responsibilities and powers of the board, the position of the board is very fundamental in determining the overall direction of the enterprise. It is the board which acts as a caretaker and maintains a check on the executives.

The board's role in reviewing and approving company strategy

It is widely accepted that the role of the board across the MENA region is very crucial in determining the overall strategy of the company. Although the primary responsibility of day to day management of the enterprise lies in the hands of the executives, the board holds a dominant position.

Board's role in overseeing management

It is generally the board which is responsible for appointment of the top executives and the CEO of the company, barring a few cases where it is done by the general body of shareholders. As regards to appointment of the management team, the responsibility is usually entrusted in the hands of the CEO to select him team, subject to the guidelines laid down by the board. Thus, the board is given adequate power to appoint and remove the management, along with the task of succession planning.

The board's role in implementing corporate governance structures, policies, and practices

It is the responsibility of the board to ensure that the sufficient measures are taken for successfully implementing corporate governance practices. However, in case of MENA countries the boards have generally failed to put the code of best practices into implementation.

Board Structure

In MENA countries, the board structure is predominately single-tier. As in most other Asian countries, the board is dominated by controlling family members, their close relatives and former bureaucrats who are close to the families. Thus, separation of directors from the managers is not visible in most MENA countries. In most cases chairman of the board is also the CEO of the company.

Board committees are established to ensure expertise and efficiency in decision making related to specific areas of business. Committees can be established relating to various fields, but the principal three committees which are usually recommended are – audit committee, nomination committee and remuneration committee. In MENA region a large number of corporations have put an audit committee into place, but the concept of nomination and remuneration committee is less prevalent. Also, only a small number of committees comprise of a majority of independent directors, which is not in line with the best practices code.

Board Size

The size of the board needs to be optimal. A small sized board may not have adequate skill and diversity to undertake enlightened decisions. On the other hand, a large sized board may slow down the decision making process. In the MENA region, the average board size varies at around 8-10 members, which is in line with the best practices.

Mix of executive, non-executive and independent directors

While executive directors provide the inputs and representation from the side of the executives on the board, the non-executive directors help in keeping a check over the management. In the MENA region, the mix of executive and non-executive director has been found to be reasonable, although wide regional disparities have been observed.

Having an independent director is considered to a basic ingredient of good corporate governance practice. But the region lags behind in terms of having independent directors on the board, with a majority of listed companies having none or only one independent director on their board. Even where independent directors have a place in the board, their independence is a suspect.

Women representation on board

Given the social structure of the countries, a majority of them being Islamic nations, the participation of women on board is relatively very low.

Board Processes

In the MENA region, there is a practice of giving sufficient notice about board meetings and the agenda to be discussed therein about two weeks in advance. Looking at the frequency of board meetings, a significant majority of boards meet only 4-6 times a year. Only a small percentage of companies have 10 or more meetings in a year.

Remuneration policies

The remuneration of directors should be paid in a manner that ensures fair and transparent working. It is seen that in the MENA region, remuneration committees are not too popular and the remuneration is determined by the board or the shareholders. Also, there is lesser focus on having a performance based compensation for the executive directors. Stock options are not too popular in the region. As a rule, executive directors are not supposed to get any additional fee for being on the board but surprisingly around 40 % of the executive directors in the MENA region do receive such remuneration.

Board Evaluation and Training

In the MENA region, less than 20% of the companies opt for such a practice. Also, there is a need to train the individuals in various aspects relating to corporate governance before them

being inducted onto the board. Even in this aspect the region is lagging behind the global standards.

Control Environment and Processes

The basic purpose of implementing a robust control environment and processes is to ensure that the company and its shareholders are protected against possible misstatements, mismanagement, frauds and other abuse of powers. The principal means of ensuring this is by means of internal control and audit.

Risk Management

Companies with a deliberate focus upon risk management are likely to earn higher profits. But a look at the MENA region shows that less than a quarter of the listed companies have risk management measures in place in the form of a dedicated committee or executive. This practice certainly calls for further improvement in this direction.

Internal Control

Internal control systems are established in an organization to ensure that the assets are not misappropriated, proper accounting records are maintained and financial reporting is fair. But in the MENA region, less than half of the listed companies and banks have an internal control system in place. Also, the internal control function is supervised by the board in majority of cases; there are significant number of instances wherein it is supervised by the senior executive. Such a practice is not recommended as it directly influences the independence of the internal control team.

Compliance

'Compliance means compliance with the conduct of business rules imposed by laws and regulations, as well as internal rules and procedures.' Usually for this procedure a compliance officer is appointed which reports to the top management. In the MENA region, only about a quarter of listed companies have taken step in this regards.

Internal Audit

Internal Audit is carried out with the primary objectives of evaluating the effective implementation of the internal control and risk management. In the MENA region, it can be seen that a high majority of companies have an internal audit system in place. This is a good sign, as it ensures fair practices in the organization. But as discussed earlier, the composition of audit committees was such that there were fewer committees with a majority of independent directors. This could lead to serious concerns about the independence of the internal audit functions being carried out.

External Audit

The external auditor has the responsibility to evaluate and state whether in their opinion, the financial statements and records of the company show a ‘true and fair view’ of its financial position. In the MENA region, almost all the companies get their books of accounts audited by an independent external auditor.

It is very interesting to note that more than 75% of the listed companies and banks have been hiring International Audit firms to get their books audited. Thus, local firms and individual auditors form a small minority in taking up the audit assignments. The audit work done by the reputed international firms, certainly commands more credibility.

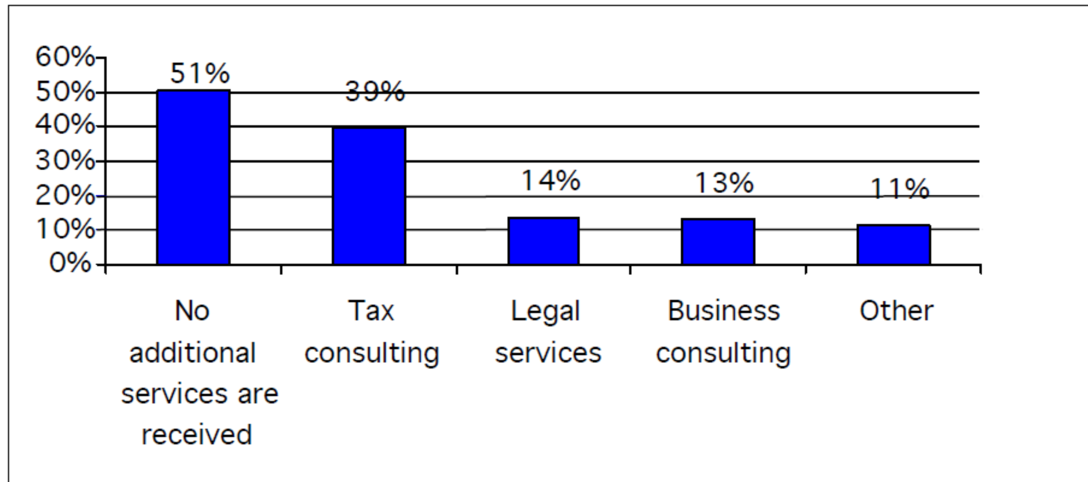
Also, there has been an emerging concern about the ‘Rotation policy of the auditors.’ It is recommended that a company should periodically change its auditors in order to avoid collusion and unfair practices. Looking at the MENA region, it could be seen that only 32% of the listed companies and banks in the region have an auditor rotation policy and more than half of the companies had not changed their auditors in the last five years.

Ideally, the appointment of the external auditor is to be done by following a systematic procedure. The audit committee should invite bids and take the suitable applications into consideration to be recommended to the board. The auditor should ultimately be appointed by the shareholders. In the MENA region, the issue of appointment of auditor is duly taken care of in a majority of cases, with around 70% of the listed companies entrusting this responsibility with their shareholders.

In general, it could be said that the practices in the MENA region in respect of external audit are satisfactory. There are certain areas that may need reforms, but the overall picture is in line with the code of best practices.

Provision of non-audit services

It is to be recommended that the auditor should not provide any non-audit services to their clients that may jeopardize their independence. As per the Hawkamah-IMF survey, a majority of external auditors (51%) did not provide any non-audit service to the clients. A significant number also provided the tax service, and a few firms provided their clients with legal and consultancy services. It is to be ensured that no conflict-of interest arises due to provision of these services by the auditors.



Audit Committee

The role of the audit committee is to develop recommendation on the selection of an external auditor and the fees to be paid to them, develop framework for internal control and risk management, oversee the periodic financial reporting procedures implemented by management and, ensure compliance to the law of the land and internal codes and guidelines.

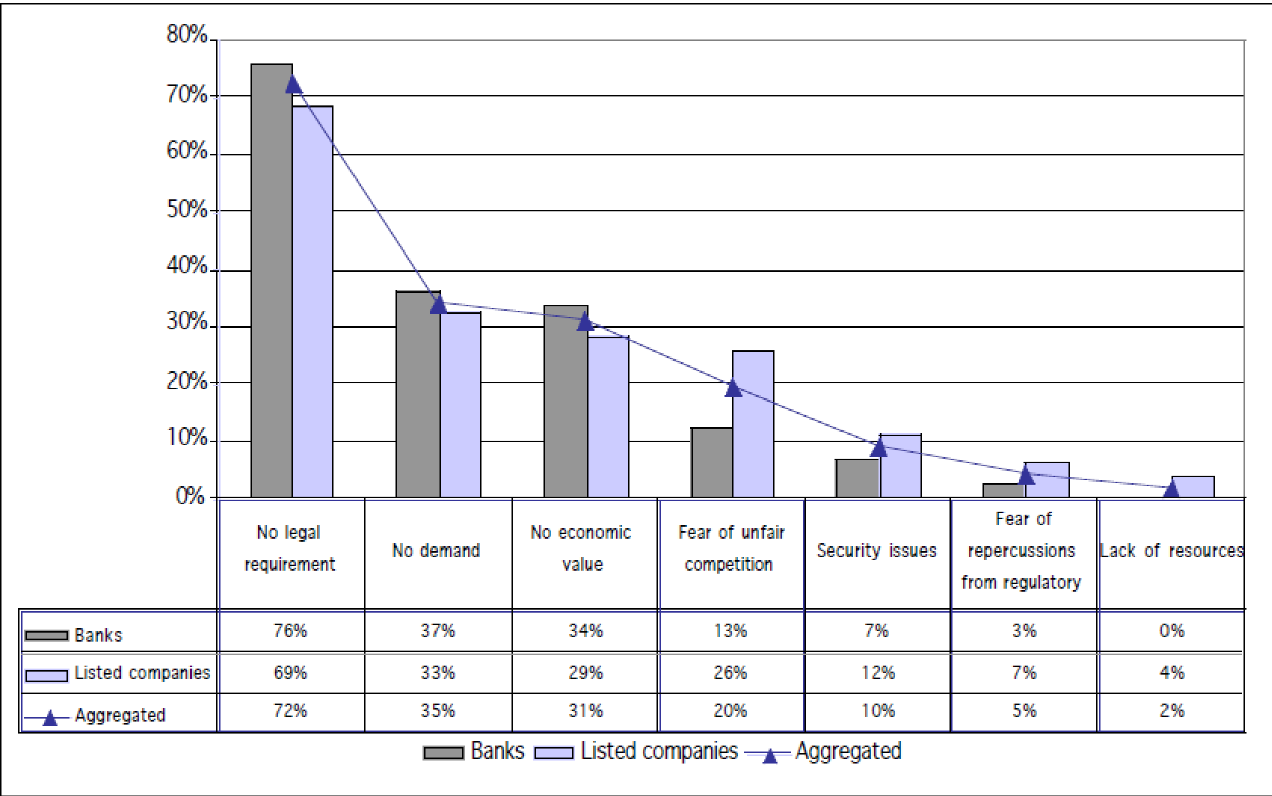
Looking at the MENA region, the Hawkamah survey reveals that the role of the audit committee of listed companies and banks in terms of various parameters is satisfactory except with respect to compliance function. The audit committees in the region have failed to take up the responsibility to ensure that the board and the executive bodies act in compliance with the legal requirement, the charter and the by-laws. The audit committee must also have better composition and needs to provide higher representation to the independent directors.

Disclosure and Transparency

Disclosure and transparency are crucial factors in corporate governance. Adequate disclosures by companies lead to confidence in stakeholders towards the company. A company with transparent practices is weighted significantly higher by the investors. A business with transparent practices would ensure that the board and the management could be held accountable for their acts. As a result, better performance is ensured on the part of board and management, and the chances of frauds and mismanagement are reduced.

Disclosure Aversive Behavior

The ownership pattern of the business enterprises in the MENA region is mostly family based and concentrated in the hands of public sector enterprises. Thus, there had been a general fear against public disclosures of business information. The following cause were identified in the Hawkmah-IFC survey-



	No legal requirement	No demand	No economic value	Fear of unfair competition	Security issues	Fear of repercussions from regulatory	Lack of resources
Banks	76%	37%	34%	13%	7%	3%	0%
Listed companies	69%	33%	29%	26%	12%	7%	4%
Aggregated	72%	35%	31%	20%	10%	5%	2%

Looking at the above figure, we note that disclosures have been primarily gained come into picture because of legal requirement, rather than on the voluntary basis.

Apart from this, there is a fear amongst owners of competitors using their information to their advantage and that disclosed information may further attract the interference of regulators. It is surprising to note that a significant number of companies hold a belief that the disclosures do not have any economic value addition.

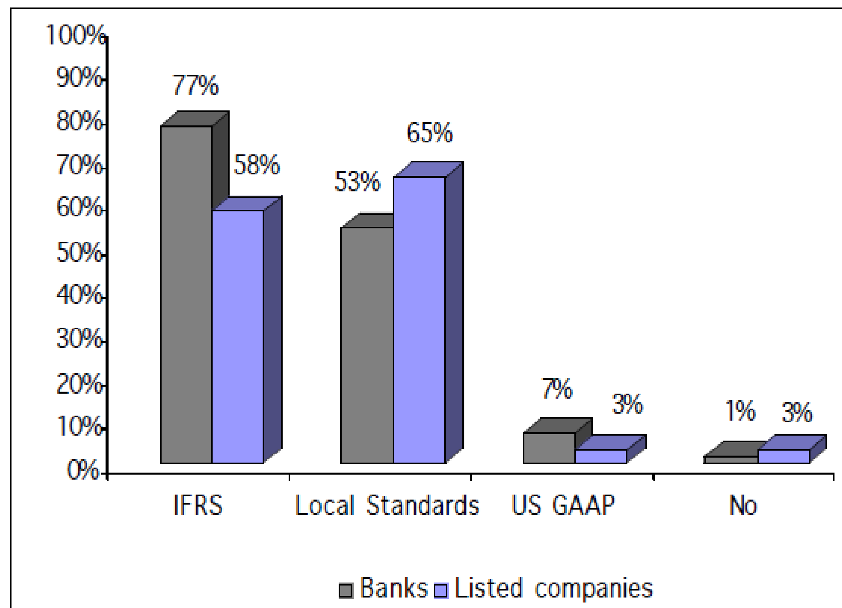
Information to be disclosed

The information to be disclosed by a company could be broadly classified into financial and non-financial information.

FINANCIAL DISCLOSURE

Financial disclosure includes financial statements of the company including the income statement, balance sheet, cash flow statements, notes to accounts and other related documents. In the MENA region, the financial information is generally disclosed adequately. This is due to the fact that regulations in this regards are detailed, specific and compulsory. The companies in MENA region duly communicate the financial information to their shareholders through local newspapers, general body meetings, annual reports and company websites, which is in line with the code of best practices.

But merely disclosing financial information is not sufficient, it is essential to ensure that the financial statements are prepared in compliance with the specified accounting standards. Looking at the data of listed companies from the MENA region, we observe that a large number of companies are preparing their financial statements based on International financial reporting standards. Over the years, there has been a gradual convergence towards IFRS which would help companies better in an increasingly globalized environment. In some of the countries in the MENA region, it is compulsory to prepare financial statements adhering to local standards.



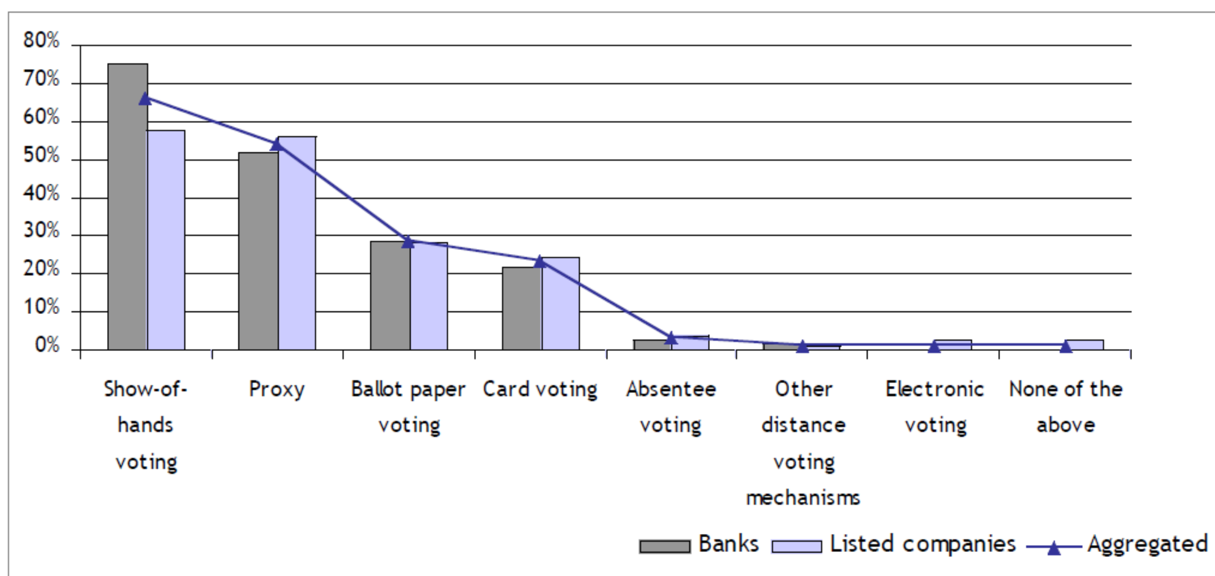
NON-FINANCIAL DISCLOSURES

Along with the financial disclosures, non-financial disclosures are also important comprising of ownership pattern, voting rights, key company related documents and corporate governance disclosures. The region has certainly been a poor performer with respect to disclosure of non-financial information. Such information's are not disclosed on a voluntary basis, but are generally given when requested by a shareholder.

Shareholder's Rights

Protecting the rights of the owners of a company is very crucial from the perspective of corporate governance, Securing the rights of shareholders would lead to increased investor confidence, leading to better availability of funds and well developed capital markets. The rights of shareholders are usually secured up to a certain extent by the regulatory framework, but it is essential for companies to go beyond the mandatory requirements and ensure best corporate governance practices in this regard.

In the MENA region, it is seen that generally the majority of the shareholders do participate in the meetings. In respect of voting rights, it is seen that the region has a relatively underdeveloped system, as demonstrated from the given figure. It is astounding to note that in about 66% of the cases voting was done by show of hands and electronic voting is used in less than 5% of the



cases. Proxy voting and ballot paper voting are also not much prevalent. Thus, it can be observed that the region remains relatively underdeveloped in this regard.

In respect of circulating regular and timely information to the shareholders, it is generally seen that the shareholders are duly informed about general meetings well in advance. Also, the relevant material is provided in sufficient quantity to the shareholders.

An overall observation of the region's progress in terms of shareholders' rights looks satisfactory, although there is still a scope of improvement in certain aspect.

7.4 Conclusion

Having looked at the various aspects of corporate governance practices in the MENA region, we find that the corporate governance practice is still in its nascent stages in the present times. Given the specific family based and public sector dominated ownership pattern in the region, a lot needs to be done in the direction of corporate governance reforms.

In the past decade, the issue has certainly gained momentum with a number of countries releasing their codes of conduct and revising their corporate governance laws in line with the code of best practices. Corporate governance institutes have also made significant contribution in this direction. A special mention needs to be made regarding 'Hawkamah – Institute for corporate governance' based in Dubai, for its outstanding efforts.

With increasing globalization and integration of national economies, the need for good governance has even been felt by the corporates and, initiatives are being undertaken by some of the private sector undertakings as well on a voluntary basis. Even within the region, a lot of disparities could be observed. While countries like Bahrain and Qatar have formulated excellent codes for corporate governance, countries like Iraq still lag behind to establish good governance.

Thus, it is essential that nations with a relatively underdeveloped system may take cues from their counterparts and proceed further.

Like in most Asian countries, MENA countries have the major challenge of legal enforcement and accountability. Companies and securities laws have been updated in most countries but enforcement needs to be strengthened. Most MENA countries have developed their own corporate governance codes using OECD Principles as the benchmark.

Apart from working on the legislative and regulatory front, efforts need to be made to transform the attitudes towards good governance. It has been observed that a need was felt in the rest of the world in the aftermath of corporate scams and failures. The region should take learning from such incidents and be prepared to prevent such adversities. But the already developed codes should not be blindly applied onto the region. Suitable changes should be made keeping in view the specific needs of the region in terms of the Islamic laws, cultural factors and economic conditions. Under mounting global pressure and growing consensus in the region, the corporate governance practices in the region are set to advance significantly in the next few years. A shift from a voluntary practice to a mandatory compliance regime is required in the initial stages to promote the practices in the region. In the later stages, the concept of self-regulation may be put to use.

7.5 Recommendations on Improving Corporate Governance

Following are the recommendations on improving corporate governance in the MENA region countries which have been elaborated by the Working Groups of the MENA-OECD Investment Programme in 2006.

1. The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities;
2. Improving corporate governance in the MENA requires the implementation of national and regional reforms drawing on the goals developed in the OECD Principles of Corporate Governance.
3. MENA countries should intensify their efforts to improve the regulation and corporate governance of banks. Furthermore, the role of the banking and financial sector as a vehicle for improved governance in the corporate sector needs to be explored.
4. MENA countries should strengthen their respective accounting, auditing professions and professional bodies and ensure the adoption of international standards.
5. Governments should intensify their efforts to strengthen the corporate governance of state-owned enterprises, in particular by improving transparency, clearly defining the ownership responsibilities of the state and by improving the role of the boards in overseeing the strategy, management and internal controls of the enterprises.

6. Home-grown efforts in improving corporate governance have been effectively steered by National Corporate Governance Task Forces in some MENA countries. Their experience should be built upon in the rest of the region.

References

Koldertsova, Alissa (2008) *Private Sector Development in the Middle East and North Africa: Making Reforms Succeed*. OECD

IFC-Hawkamah (2008) *MENA wide Corporate Governance Survey*

Naciri, A (2008), 'The MENA Countries National Systems of Corporate Governance' In A. Naciri (ED) *Corporate Governance Around the World*, Routledge

8

Corporate Governance in SAARC Nations

8.1 About SAARC

The South Asian Association for Regional Cooperation (SAARC) was established on December 8, 1985 when the Heads of State or Government of Bangladesh, Bhutan, India, Maldives, Nepal Pakistan and Sri Lanka formally adopted its Charter. Afghanistan was added as the eighth member of SAARC in 2005. The objective of SAARC is to provide a platform that would facilitate the spirit of friendship, strengthen collective self-reliance and promote active collaboration between people of South Asia. It aims to accelerate the process of economic and social development in Member States.

The most striking feature of corporate governance in SAARC nations is that a number of corporations in heavy industry, infrastructure and banks are under the control of the state. The companies in the private sector are mostly owned and managed by business groups and families which often control the appointment of all the directors to the board of directors generally instituting family members and close relatives at the top managerial positions. Most of the companies are plummeted by poor disclosure and transparency, vague governance structures and expropriation of minority shareholders' interest.

The typical agency conflict of owner-manager noticed in the USA and UK does not exist in SAARC nations owing to combining of ownership and control. The agency problem that prevails is the conflict the owners that have a control or have a majority stake and other minority shareholders of companies. The reforms in corporate governance in SAARC countries over the last two decades have attempted to provide protection to minority shareholders through laws and regulations but these have proved to be either inadequate or poorly administered. The SAARC nations are marked by a low market capitalization, less developed stock markets and poor regulations.

8.2 Pakistan

8.2.1 Introduction

The economy of Pakistan economy is made up of the services sector (50 per cent), industry/manufacturing (25 per cent) and agriculture (25 per cent). Agriculture is a mainstay of the economy, accounting for up to 25 per cent of total GDP with 44 per cent of the country's population depending directly or indirectly on agriculture for their livelihood. Social and political instability undercuts meaningful progress toward a stable macro-economic environment.

Corruption, widespread throughout the country remains a serious hindrance on long-term economic development. The overall regulatory environment continues to be affected by complicated administrative bureaucracy, and there is little commitment to opening markets.

8.2.2 Pakistan Debt Crisis of 1998

In the years leading up to 1998, Pakistan saw seven different political administrations and military chiefs at the helm. This political instability along with social volatility, coupled with an unacceptably high fiscal deficit, an ongoing trade deficit and overwhelming amount of default on loans characterized the economy in the years leading to the crisis. The public debt/GDP ratio debt touched 102% in 1998-99 and external debt/GDP ratio went above 50%[81].

Surprisingly, in spite of heavy debts Pakistan averted the East Asian crisis of 1997-98. However, it was a non-economic event that triggered Pakistan's Debt Crisis of 1998. The tensed domestic political environment led Pakistan to retaliate to five nuclear arm tests conducted by India with nuclear arms tests of its own, despite warnings by the international community. This aggravated Pakistan's already perilous condition and pushed it over the edge into crisis mode.

In this grim situation, Pakistan was forced to obtain additional external loans from International Monetary Fund (IMF) subject to the conditions of implementing tough austerity measures. As a result of this, Pakistan faced an additional economic crisis in the form of escalating double-digit inflation, which reduced aggregate demand, investment, employment, economic growth and increased poverty.

In the post-2000 period, with a more stable government doing reasonably good management of economic affairs, Pakistan was able to break the vicious circle of debt. All the macro-economic indicators improved by 2003-04. This was made possible with rescheduling of foreign debt with the Paris Club, to the tune of $12.5 billion[82].

8.2.3 Corporate Governance in Pakistan

In Pakistan, consciousness of significance of good corporate governance is high among the policymakers. Pakistan's capital market has seen a sequence of structural reforms since 1991. Amendments in important laws, including Security and Exchange Ordinance, 1969, Companies Ordinance, 1984, and Securities and Exchange Commission of Pakistan Act, 1997, were made in Pakistan. The Securities and Exchange Commission Pakistan (SECP) was established in 1999 as the market regulator which took over the responsibilities and powers of Company Law Authority. Since its inception, SECP has been particularly active in keeping pace with the reforms in the world in the arena of corporate governance.

---

[81]Khan, T. A., Economic viability of the Issuance of Euro-Bonds In The Perspective of Debt Crisis of Pakistan

[82] Op cit

On the lines of Sarbanes-Oxley Act, 2002 of the USA, SECP enacted Pakistan's Code of Governance in 2002. It was subsequently made part of the listing regulations of the three stock exchanges- Karachi Stock Exchange, Lahore Stock Exchange and Islamabad Stock Exchange and became applicable to all public listed companies.

With the constantly evolving needs of the corporate sector to meet the changes of the dynamic business environment and to ensure transparency and accountability, the SECP introduced amendments to the Code in 2012. The objective was to further improve the standards and keep the governance framework in line with the global developments.

With a combined market capitalization of $120 billion dollars at its exchanges, Pakistan is one of the fastest growing emerging equity markets. Karachi Stock Exchange rose by 40% in 2013, in local currency terms, making it one of the top performing stock exchanges in the world[83].

SECP also issued a separate draft code for unlisted companies in 2013. The non-listed companies represent the majority of businesses in Pakistan. Almost 60,000 non-listed companies are registered with the SECP compared to 595 companies listed on country's stock exchanges. The recent years have seen SECP become progressively more active in implementing its relatively strong authority. A more activist regulatory approach has meant passage of a revised Code and imposition of serious penalties in case of failure of corporate governance measures in the country. The gap between law and practice continues to be bridged with strengthening regulatory enforcement measures.

The State Bank of Pakistan, the country's central bank, has put in place a stringent regime for the governance of financial institutions to safeguard the interests of shareholders and depositors. The banking industry in Pakistan has seen some high-profile financial scandals, despite regulations and supervision by regulators. It has resulted in greater analysis by media and stakeholders of the corporate governance practices of the financial institutions.

The Pakistan Institute of Corporate Governance (PICG) was created in 2005 as a public-private partnership, with the goal of training the directors and senior managers to better the practices of corporate governance in financial institutions. The Institute provides knowledge and tailor-made training to assist financial institutions in Pakistan to overcome their distinctive governance challenges. PICG has been collaborating with International Finance Corporation, a World Bank group company, in building sustainable institutional capacity for governance training.

These organizations are key to the implementation of corporate governance standards and have ensured an increasing awareness of the same.

[83]http://www.finance.gov.pk/survey/chapter_12/06-CapitalMarkets.pdf

8.2.4 Ownership Pattern in Corporations

The ownership structure in corporate Pakistan like most Asian countries is highly concentrated. Closely held firms, controlled by family or state or by financial institutions, characterize the corporate sector. The leading agency problem is that of expropriation by the controlling shareholder, disregarding the interests of minority shareholders. Pyramid ownership structure, cross shareholding and interlock directorship allows shareholders of a company to perform controlling rights. Control over the company can be maintained while owning a small fraction of ownership.

The minority shareholders' rights are not well protected. According to Companies Ordinance of Pakistan 1984, if there occurs any misconduct in a business by other shareholders, then only the shareholder who is having at least 20% shareholding in a company may ask for help from the court. The shareholders representing 10% shareholding can lodge a complaint to SECP. The Company Ordinance 1984, and the code of corporate governance do not deal with the protection of rights of shareholders that have shareholding less than 10% and in this way minority shareholders do not get any legal protection of their rights. (Companies Ordinance Section 263, 290)

8.2.5 Board Structure

Pakistan follows a unitary board structure, with some mandatory provisions regarding non-executive and independent directors. As Pakistan law was based on the laws prevalent in British India, its provisions regarding board structure find consonance with the Anglo-American model. Though, it might be noted that some provisions provided by the corporate governance code of SECP, for example, protection of the rights of the stakeholders other than shareholders, that is, the employees, the creditors, the financiers etc. are taken from the European-Continental model as well (Tahir et al, 2012).

8.2.6Corporate Governance Code

In March 2002, the Securities and Exchange Commission of Pakistan released the first Code of Corporate Governance for public companies to improve standards of corporate governance in public listed companies. A new Code of Corporate Governance in April 2012 was issued by the SECP to meet the global standards. Pakistan Institute of Corporate Governance played a key role in the process of the revision, as SECP had mandated a task force consisting of members of PICG for the review exercise[84].

[84]Code of Corporate Governance (2012); Securities and Exchange Commission Pakistan

The major revisions to the new Code are centered on the areas of constitution of the board of directors, board committees, separation of the office of the CEO and chairman, removal and qualification criteria for CFO, Company Secretary and Head of Internal Audit, evaluation procedure of the board and training of directors.

The onus for overall management and direction of the affairs of a company falls on the board of directors. The board is entrusted to ensure the truthfulness of accounting and financial reporting systems. The revised Code by SECP seeks appropriate representation of minority interests and requires the board of directors to enforce it. Contrary to the Code introduced in 2002, the new Code makes the representation of at least one independent director compulsory while preferring one third of the board to comprise of independent directors. A more wide-ranging criteria for assessment of independence of the directors has been recommended by considerably expanding the requirements stipulated for the same earlier along with prescribing a formal and transparent procedure for remuneration of directors with appropriate collective disclosure in the annual report[85].

Moreover, the number of executive directors, which was limited to not more than three-fourths of elected directors including CEO, has been fixed by the revised Code at maximum of one-third of the elected directors. Multiple directorships have been limited to a maximum of 7 at a time to ensure commitment and quality participation. However, this limit ignores directorship in listed subsidiaries of a listed holding company.

Directors' training has been made essential in the new code, however, the code allows flexibility and range of choice with respect to attaining training from an institution, local or foreign, that meets a set standards approved by the SECP. Earlier such directors' training was compulsorily to be acquired only from the PICG which limited the choice and outreach[86].

Globally, effective boards on specific areas form board committees. This approach allows the boards to concentrate on broader and strategic issues and strengthens the board's governance role. Mainly these committees include Audit Committee, Nomination Committee or Human Resources and Remuneration Committee. The Code 2012 requires the board of directors of every listed company to establish an Audit Committee and Human Resource and Remuneration Committee. The Audit Committee shall include at least three members comprising of non-executive directors with the Chairman being an independent director. The Human Resource and Remuneration Committee must consist of a majority of non-executive directors, including preferably an independent director. The CEO may be included as a member of the committee but not as the chairman and also shall not participate in the proceedings on matters directly related to his or her performance and compensation.

Further, bearing in mind the critical role of the head of internal audit in ensuring effective

[85]Op cit
[86] Op cit

internal control arrangements and promoting good corporate governance, exhaustive qualifications in terms of education and experience have been specified. Also, such criteria for the company secretary and chief financial officer have also been laid down.

In a progressively globalized world economy where competition is intense, the acceptance of good corporate governance practices can make a real difference to how companies are viewed both domestically and within the international community. The revision of the Code marks an important breakthrough in the development of corporate governance in Pakistan.

8.2.7 Implementation Challenges

Due to many distortions in economy, market forces do not reward good governances or punish unethical practices. The large part of the undocumented economy discourages promotion of transparency and accountability in companies. Overall management structure is also not conducive to establishing the norms of good governance. Many companies in listed Stock Exchange are not fully practicing the code of good governance. Tightly held ownership, lack of professional skills, missing change agents, audit dependability and overall structural weaknesses are bottlenecks in developing the corporate governance in the companies (Tahir et al, 2012).

8.3 Sri Lanka

8.3.1 Country Analysis

Sri Lanka known as a "pearl of Indian Ocean" is categorized as a middle income country as it recorded an average growth of averaged 6.3 percent between 2002 and 2013, with Gross Domestic Product (GDP) per capita rising from US$859 in 2000 to US$3,256 in 2013[87], driven by faster expansion in industry.

The country's economy has been traditionally based on agriculture which now contributes less than 20% to GDP and employs a third of work force. Export of tea, coffee, rubber, coconut, cocoa, tobacco, cinnamon, cardamom, pepper, cloves, etc.; port construction; telecommunications; and offshore insurance and banking are important industries in Sri Lanka.

8.3.2 Corporate Sector

The corporate form of business was introduced in Sri Lanka during British colonial rule (1796 to 1948) in the country. Most of the corporate entities presently listed on the Colombo Stock Exchange have been formed during British rule and continued after independence with or without foreign owners or formed through amalgamation of several entities formed during British rule.

[87] www.worldbank.org/en/country/srilanka/overview

Sri Lanka adopted the Anglo-Saxon model due to the British legacy of colonial rule including one-tier board of directors, participation of shareholders in corporate decision-making, protection of minority shareholders, dominant role of stock market, market for corporate control and takeovers, and performance based executive compensation, etc. With the introduction of liberalized economic policies in Sri Lanka in year 1977, private sector companies started playing a dominant role in the Sri Lankan economy promoted by deregulation and economic liberalism.

8.3.3 Corporate Governance Reforms

The collapse of finance companies in 1980s, downfall of Vanik incorporation and bankruptcy of Pramuka bank in 1990s and opening up of the economy in 1977 unleashed the reforms in corporate governance in Sri Lanka. The corporate governance reforms carried out in Sri Lanka from 1997 onwards are through the codes of best practices on corporate governance which address core corporate governance perspectives. These codes were issued as voluntary codes, which were not in much detail but had strong disclosure element. Lately, along with these voluntary codes, various mandatory codes on corporate governance have been introduced. Both these voluntary and mandatory codes mainly prescribe principles and practices for improving corporate governance of listed companies[88].

The first voluntary code 'Code on Best Practice' based on Cadbury code (1992) was designed to achieve the high standards of corporate behavior by strengthening the board of directors and increasing its effectiveness. to deal with financial aspects of corporate governance. This code was issued in December 1997 by the Institute of Chartered Accountants of Sri Lanka (ICASL).

A number of guidelines and supplementary codes to ICASL Code were developed during 1998-2003 to deal with specific areas of corporate governance. These include 'ICASL Code of Best Practice on Audit Committees 2002' which provided detailed guidance on the scope and functions of the audit committee of listed companies, 'Code of Corporate Governance for Banks and Other Financial Institutions 2002' issued by the Central Bank of Sri Lanka and 'Guidelines for Listed Companies in respect of Audit and Audit Committees 2004' issued by the Securities and Exchange Commission (SEC)[89].

The ICASL Code (2003) was subsequently replaced by the 'Code of Best Practice on Corporate Governance (2008)', which has been prepared by joint initiative of ICASL and the SEC in consultation with Colombo Stock Exchange (CSE). Along with ICASL code (2003) a series of mandatory rules on corporate governance have been incorporated into the CSE Listing Rules. This Code provided a number of revised recommendations on corporate governance best

[88]Senaratne, Samanthi(2011) 'Corporate Governance Reforms in Sri Lanka' *Sri Lanka Journal of Advanced Social Studies* Vol 1(1)
[89] Ibid

practices under the two main headings 'The Company' and 'Shareholders', based largely on the UK Combined Code 2003 on Corporate Governance[90].

8.3.4 Challenges of Corporate Governance in Sri Lanka

As in most other Asian countries, companies in Sri Lanka have concentrated ownership structure different from wide-spread shareholdings in Anglo-Saxon countries. Sri Lanka has adopted the Anglo-Saxon Model of Corporate Governance specifying among others, the board structures with a mix of non- executive and executive directors with a strong element of independent directors. However, majority of non-executive directors in companies are not independent because they either represent a substantial shareholder or hold cross directorships with other directors of the company or in companies with which the company is having business dealings. The ultimate controlling shareholder in most Sri Lankan companies is an individual or a family[91].

Inadequacies in the Sri Lankan legal structure for the protection of investor's rights have given rise to the agency problem between the controlling shareholders and the minority shareholders. Thus, the challenge of corporate governance in Sri Lanka is the protection of the rights of minority shareholders.

Another challenge faced by Sri Lankan economy is the absence of market for corporate control. Banks and financial institutions are major source of funds for companies in Sri Lanka.

Another major weakness of corporate governance in Sri Lanka is the presence of several codes of corporate governance both voluntary and mandatory which leads to lack of uniformity in the corporate governance compliance by listed companies. Compliance with best practice is inadequate owing to lack of a proper enforcement mechanism to ensure that companies actually comply with best practices.

Sri Lanka has adopted the Anglo-Saxon model and attempted reforms on those lines without taking cognizance of actual conditions within the economy. Sri Lanka needs to identify the broad corporate principles and thereafter develop certain specific rules and prescriptions to suit the various sectors and to protect the interests of all the stakeholders of the company.

[90] Ibid

[91] Senaratne, S and Gunaratne, P. S. M. (2008) 'Corporate Governance Development in Sri Lanka: Prospects and Problems' *Conference Proceedings of Sixth International Conference on Business Management,* University of Jayewardenepure, Sri Lanka

8.4 Nepal

8.4.1 Country Analysis

Nepal is among the world's poorest and least developed countries with a very little foreign direct investment. The mainstay of the Nepalese economy is agriculture which accounts for 41% of the GDP with more than 80% of the population dependent on it. After agriculture, manufacturing, trade and tourism are the main activities in Nepal. Readymade garments and hand knitted woolen carpets are flourishing export oriented industry in Nepal. Nepal suffers from political instability, rampant corruption in politics and government.

8.4.2 Market Profile

Nepal has a small but active equity market with a large number of retail investors. In 2014 Nepal Stock Exchange has 334 companies listed on it with a market capitalization of $7.9 billion. The majority of market capitalization and trading volume is made up of banks and other finance companies, which are required to be listed by Nepal Rastra Bank (NRB)– the central bank of Nepal. Important legislation guiding the capital markets includes the Company Act 2006 and the Securities and Exchange Act 1983. Securities and Exchange Board (SEBO) is the capital market regulatory body.

Nepal Rastra Bank is the main institution in leading the corporate governance reforms through a series of legislative measures as NRB has been given authority to supervise corporate governance standards for commercial banks and other financial institutions[92].

Nepal is confronting with the problems of state of underdevelopment, turbulent socio-political situation, rebuilding the country after a series of devastating earth quake in 2015. Weak regulatory provisions on investor protection corporate governance have slowed the development of capital markets in Nepal. However, awareness of the importance of corporate governance is growing. NRB has issued directives for good corporate governance practices in banks and other financial companies. Banks and Financial Institutions Act 2006 also introduced key legislations on disclosures and transparency.

8.4.3 Ownership pattern

The corporate sector in Nepal is in nascent stage. The majority of the businesses in Nepal is owned by a few business families and is small and medium. The business houses dominate the ownership in corporate enterprises. The Government holds shares in a few banks and financial institutions. The foreign participation in capital markets is limited and not all the sectors have

[92]Regmi, U. R. (2012), Stock Market Development and Economic Growth: Empirical Evidence from Nepal;

Administration and Management Review

been opened up for foreign ownership. Most of the subsidiaries of foreign multinationals incorporated in Nepal are closely held and only a few of them are listed.

8.4.4 Board Structure

Nepal has a single tier board system. Though the board consists of members not affiliated with the controlling family and most companies have separate chairman and CEO, the controlling family as in other SAARC nations, remains in charge of both the board and company management.

8.4.5 Corporate Governance Code

The Government of Nepal and Nepal Rastra Bank are working towards a transparent, competitive and strong financial sector. Several measures have been taken over the years in this direction[93] . These include the directives from Nepal Rastra Bank, incorporating new provisions in Companies Act 2006, Banks and Financial Institutions Act 2006 and introduction of accounting standards (issued by Accounting Standards Board (ASB) of Nepal).

NRB has issued directives to comply with the provisions by licensed institutions concerning good corporate governance. It has lay down a code of conduct for the board of directors that broadly outlines their role and responsibilities. The code calls for adequate disclosures from the directors regarding conflict of interests before assuming office[94]. Directors also need to ensure non-involvement in any activity, which is against the interest of the company. To ensure transparency in the system, NRB has directed that directors of one deposit taking institution cannot act as director of another. Directors are prohibited to act as custodian or trustee of any of the customer.

In late 2011, NRB introduced a new circular under which non-executive members of the board must mandatorily head subcommittees of banks and financial institutions. NRB has also placed restriction on granting of loan to directors, employees, shareholders and firms related to such persons.

The Banks and Financial Institutions Act 2006 seeks to reduce the conflict of interests and encourage transparency in the operation of banks and financial institutions. It restricts dealing with shares by the directors and other officers and has outlined the disclosure requirement for directors regarding conflict in appointment of auditors, shareholding by family members and

[93]Thapa, R. B. (2008), Corporate Governance: Need & Significance in Nepalese Banking System

[94]Sharma, N. (2013), Disclosure Regime for Mandatory Disclosures by Banks and Financial Institutions in Nepal;

International Journal of Accounting and Financial Reporting

related party transactions[95]. The duties of the auditors and the terms of disqualifications of auditors have also been specified by this Act. With an objective of bringing expertise in the board governance, appointment of at least one professional director has been made mandatory. Additionally, it stipulates the qualification of directors and chief executive officers of the BFIs.

The provisions in Companies Act 2006 have strengthened the status of the shareholders and provide a better framework for financial transparency of the company affairs than in the past (Nepal Government, 2006).

8.4.6 Implementation Challenges

Adverse political situation over the past couple of decades in Nepal has hindered the development of a transparent and efficient system in the government as well the private sector. Frequently changing government and political unrest kept irregularities in governance norms. But, now, the Nepalese economy is rapidly integrating with global economy. However, the authorities in Nepal will have to tackle some implementation challenges to establish corporate governance system. Capital market regulator, despite all the existing laws, is unable to enforce the corporate governance code among the listed companies due to its limited capacity. Good governance is lacking in enforcement authorities themselves.

To avoid the need to follow proper corporate governance most of the business houses in Nepal are not willing to issue shares to the public even after knowing that it is cheaper than borrowing from banks. Most of the boards of financial institutions are unaware about their responsibilities, and the financial institutions that ran into trouble had their executive chairmen taking unfavorable decisions leading to the downfall of many institutions. Board members are prohibited take loan from own company, however it is common practice to take loan directly or, indirectly. Many big corporate houses running similar kinds of business are manipulating public deposits and transferring the fund within the group in their own interest[96]. Failure of many financial institutions like Nepal Development Bankand Samjhana Finance Company has highlighted the lax corporate governance practices prevalent in the country.

[95]Op. Cit.

[96]Pokhrel, D. R. (2007), Corporate Governance in Nepal

8.5 Bangladesh

8.5.1 Country Analysis

Formerly East Pakistan, Bangladesh came into being in 1971, when the two parts of Pakistan split after a bitter war that drew in neighboring India.

Bangladesh spent 15 years under military rule and, although democracy was restored in 1990, the political scene remains volatile. The political volatility comes, however, in the context of overall economic and social gains of the past decade. Yet Bangladesh remains one of the world's poorest nations. The majority of its people work in agriculture. There are a large number of medium and small-sized industries in jute, cotton textile, paper and leather. Garment manufacturing accounts for over 90 percent of export earnings. It is one of the densely populated countries in the world with a population of 150 million and faces a very high unemployment rate[97].

8.5.2 Market Profile

Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE) are the two stock exchanges in Bangladesh. 532 companies are listed on the DSE and 247 on the CSE. Each stock exchange establishes its own listing requirements and permits dual listing. The DSE is the major stock exchange.

Bangladesh has had its share of stock market booms and busts. Following a bull run during most of 2010, the Dhaka Stock Exchange (DSE) crashed in early December 2010 and by March 2011 the index had fallen by half from its all-time high.

Bangladesh has taken significant strides to improve corporate governance over the past few years. Key laws include the Companies Act 1994, the Securities and Exchange Ordinance 1969, and the Securities and Exchange Commission Act 1993. The Bangladesh Securities and Exchange Commission is the supervisor of the capital market and listed companies[98].

Bangladesh Enterprise Institute (BEI), not-for-profit and non-political think tank, was the first organization to take country-level initiative to develop corporate governance regulation.

8.5.3 Ownership Pattern

A small number of related shareholders dominate the corporate ownership. Most of securities in Bangladesh are held by individuals – who are the controlling family or members of the public – rather than institutions or other companies. Institutional investors hold a considerably less

[97]http://www.heritage.org/index/country/bangladesh

[98]Report on the Observance of Standards and Codes – Bangladesh 2009; The World Bank

portion but are sometimes represented on the board[99].

8.5.4 Board Structure

Bangladesh has a one-tier board system. The Companies Act requires that the board must have at least three members. The number of positions one person can hold is apparently not limited and does not have to be disclosed. The board reviews compliance with the Guidelines. It also reviews internal and external controls through an audit committee.

8.5.5 Corporate Governance Code

The Bangladesh Securities and Exchange Commission (BSEC) first issued the corporate governance guidelines in 2006 on the 'comply or explain' basis. Those guidelines were later revised by the BSEC July 3, 2012. This revision requires the companies to 'comply' with all the guidelines.

To ensure independence of the board, the guidelines make the separation of the roles of chairman and CEO mandatory. Realizing the significance of independence of directors, revised guidelines increase the minimum number of independent directors from one-tenth to one-fifth. Additionally, specific qualification criteria for independent directors are stipulated by the revised guidelines. Independent directors need to be nominated by the board and approved by the shareholders at the annual general meeting. The tenure of an independent director is prescribed to be that of three years which can be extended for another one term only[100].

The revised guidelines make it mandatory for the chairman of the Audit Committee to be an independent director and members of the audit committee are required to possess professional qualifications to make contribution to the affairs of the company. The audit committee is also empowered by the revised guidelines to report any material finding directly to the BSEC after expiry of six months from the date of its first reporting to the board or after reporting to the board three times, whichever is earlier. To ensure independence of the auditor, neither any partner nor any employee of the external audit firm should hold any share of the client firm during the term of the audit assignment[101].

In the 2012 guidelines, BSEC also introduced provisions to bring the governance of subsidiaries companies under its purview. The audit committee of the holding company is mandated to review the financial statements of the subsidiary company. The revised guidelines require

---

[99]Report on the Observance of Standards and Codes – Bangladesh 2009; The World Bank

[100]Biswas, P. K. (2012), Corporate Governance Guidelines in Bangladesh – Some Observations; *The Cost and Management*

[101]Op cit.

certification by the CEO and CFO that to the best of their knowledge and belief, the financial statements present a true and fair view of the company affairs, there is no materially misleading or omitted facts in the financial statements, and the company has not entered into any transactions that are fraudulent or illegal or that violate the company's code of conduct.

The company is required to obtain a certificate from a professional accountant or Chartered Secretary regarding compliance of conditions of corporate governance guidelines. The listed companies must comply with the guidelines and report their compliance statements in the annual reports, meaning that both compliance and reporting of compliance statement is mandatory.

8.5.6 Implementation Challenges

One of the key challenges for the regulators is to ensure compliance with the guidelines and other regulatory provisions. The guidelines on corporate governance need to be followed in its essence.

As most of the listed companies in Bangladesh are family-owned and family members often sit on the board, even after mandatory requirement of separate individuals to full these positions of the CEO and board chairman, there are companies which have complied this condition in letter rather than in spirit when members of the controlling family fill the positions of the CEO and the board chairperson. The guidelines do not disallow the inclusion of the board chairperson to be one of the members of the audit committee, which is likely to defeat the purpose of forming an audit committee. Another concern of the current guidelines is that there is no specific prerequisite for non-independent directors' educational and service background.

In spite of the shortcomings, the revised guidelines are considered to be constructive to both capital market participants and its watchdogs. However, the expense of compliance on part of the listed businesses may increase since the revised guidelines are issued on a 'comply' basis[102].

8.6 Bhutan

8.6.1 Country Analysis

Bhutan is one of the smallest and least developed countries of the world. Landlocked between China and India, Bhutan is basically dependent upon agriculture and forestry which is a source of livelihood for more than 60% of the country's workforce[103]. Most of the production in industrial

[102]Biswas, P. K. (2012), Corporate Governance Guidelines in Bangladesh – Some Observations; *The Cost and Management*

[103]http://www.bhutan.com/economy

sector is of the cottage type industry. Besides agriculture, forestry and cottage industry, the major sources of income for Bhutan is tourism and hydropower exports to India.

8.6.2 Market Profile

Public sector enterprise is the central feature of Bhutanese economy. Royal Government of Bhutan is the largest owner of equity with major stakes in six of the largest listed companies of Bhutan. Due to near absence of private sector participation in the market, the equity market in Bhutan remains small with turnover and liquidity being extremely low due to limited number of domestic investors and no foreign investors.

8.6.3 Corporate Sector Regulations

The corporate entities in Bhutan are regulated by the Companies Act which was enacted for the first time in 1989 and was thoroughly revised in the year 2000. The Financial institutions Act (FIA) 1992 is the key legislation for capital market. The Royal Monetary Authority (RMA)—the central bank of Bhutan—is the de facto securities market regulator.

The Companies Act defines the roles and responsibility of board. Procedures for appointment and removal of directors are also specified in the regulation. The Act provides for regime for conflict of interest and related party transactions. Conflicted directors are required to disclose their interest and recuse themselves from voting regarding that transaction. The basic rights of shareholders as laid down by the OECD Principles are in place in Bhutan[104]. The law requires the listed companies to prepare annual and semi-annual reports to fulfill disclosure and transparency requirements.

The FIA and 2002 Prudential Regulations issued by Royal monetary authority requires Financial institutions (FI) to establish an audit committee to oversee internal, external audit, financial reporting, internal control and legal compliance. They also need to implement a company code of ethics provided in regulation. There is no such requirement for other companies. Royal audit authority (RAA) provides audit firm of companies to be rotated in every three years and restrain audit firm from providing other remunerative service to the same entity in order to ensure auditor's independence.

8.6.4 Board Structure

Bhutan, as in other SAARC countries has a single-tier board system. The composition of board tends to be non-executive with board members generally connected to various shareholders. However there are no formal codes or rules regarding board composition or independence[105].

[104]World Bank's Report on Observance of Standards and Codes: Corporate Governance Country Assessment; Bhutan 2006

[105] Op cit

8.6.5 Challenges

While the Company Act provides a solid foundation for corporate governance in Bhutan, there are gaps in the law and overall legal framework. There is no regulation specifically focused on securities or capital market or on takeovers. Enforcement is limited owing to limited resources of the regulators such as Royal Monetary Authority (RMA) and Royal Stock Exchange of Bhutan (RSEB). Absence of a liquid capital market is unable to provide an exit option to the shareholders.

Bhutan lack domestic auditing and accounting capabilities in the private sector. There is no domestic licensing or certification in respect of auditing and accounting. Generally members of Institute of Chartered accountants of India (ICAI) are used by Bhutanese companies for their auditing requirements. The market for corporate control is not transparent. Also there is no law on takeovers. Regulations are required to be introduced in Bhutan to create bodies for auditing oversight and regulating the capital market. Capital market reforms such as allowing foreign portfolio investment may be initiated to make capital markets more efficient and transparent.

Another challenge is that Bhutan does not have any code of corporate governance to provide guidance for boards on board composition, independence, roles, duties, and responsibilities.

8.7 Maldives

8.7.1 Country Analysis

The Maldives is an Islamic republic which lies off the Indian sub-continent. It is made up of a chain of nearly 1,200 islands, most of them uninhabited. With its abundant sea life and sandy beaches, the Maldives is portrayed by travel companies as a tropical paradise. The economy revolves around tourism, and scores of islands have been developed for the top end of the tourist market[106]. With no system of direct taxation, the government relies heavily on import taxes, tourism taxes, and income generated by state-owned enterprises. Weaknesses of the economy include chronically high government spending, an inefficient and outsized public sector, and widespread corruption. The state still plays a large role in the economy through state-owned enterprises, limiting private-sector activity. Public ownership is widespread in every sector except tourism and remains the largest source of employment, hiring over one-third of the formal labor force.

---

[106]http://www.heritage.org/index/country/maldives

8.7.2 Market Assessment

The Capital Market Development Authority (CMDA) was established under the Maldives Securities Act 2006 which is responsible for regulating and developing the capital market in the Maldives. The CMDA has been instrumental in developing the regulatory environment as well as the infrastructure for the organization of the securities market. The capital market of Maldives is very narrow and in nascent stage of development. In 2012, the CMDA signed an agreement and is actively pursuing development of an Islamic capital market in the country. The reforms have been attempted to attract foreign listings and foreign capital to Maldivian companies both through the Maldives Stock Exchange and listing abroad.

8.7.3 Code of Corporate Governance

In 2007, the Capital Market Development Authority (CMDA) launched a code of corporate governance which applies to all listed companies, regardless of the nature of their business. Other public companies are strongly encouraged to comply with the provisions of the Code.

The code requires the board of directors to have a mix of executive, non-executive and independent directors. At least half the Board should comprise non-executive directors, with a majority of such non-executive directors being independent directors. At least two members of the Board should be executive directors.

As per the code, chairman and CEO of a company must be separate persons, to ensure an appropriate balance of power and increased accountability. The whole responsibility of ensuring that the company complies with all relevant laws and regulations, including the code of corporate governance falls on the board.

The audit committee is required to comprise of at least three non-executive directors, and majority of whom, including the Chairman, must be independent. The Board must ensure that the members of the audit committee are duly qualified with at least two members with accounting or related financial expertise or experience. All listed companies must have an internal audit function within the company. The external audit partners should be rotated every five years for all listed companies.

The nominating committee should identify suitable candidates for Board appointments or reappointments and make recommendations to the board. When nominating new directors, the nominating committee should consider the mix of directors' characteristics, experiences, diverse perspectives and skills that is most appropriate for the company. Shareholders should have an opportunity to nominate Board candidates, with at least 21 days' notice provided to shareholders to allow them to make their nominations.

The board of directors is also required to set up a remuneration committee to recommend remuneration packages for each director and the CEO. The remuneration committee should

comprise of at least non-executive three directors and majority of whom, including the chairman, must be independent[107].

8.7.4 Challenges

By promoting the awareness of the corporate governance code and advocating quick compliance, Maldives hope it will be able to soon meet the important challenge of improving the investment climate and reducing the cost of capital. Currently only a handful of companies are listed. The code expects that enormous benefits accruing from good corporate governance will be validated by these companies will to all others in the country[108].

8.8 Afghanistan

8.8.1 Country Analysis

Afghanistan is one of the world's poorest countries. Afghanistan's economy is recovering from decades of conflict and terrorist activities. The economy has improved significantly since the fall of the Taliban regime in 2001 largely because of the infusion of international assistance, the recovery of the agricultural sector, and service sector growth. The Afghan economy remains hobbled by poor infrastructure, insurgency, and corruption. The agricultural sector depends heavily on cultivation of the opium poppy, and illegal drug trafficking fuels violence and instability.

8.8.2 Code of Corporate Governance

There is no code of corporate governance currently in place in Afghanistan, except for the banking industry. The Commercial Code Law of State Owned Enterprises, Insurance Law and the Law of Limited Liability Companies and Corporations do not contain any legislative provision to on corporate governance. However for banks, a code of corporate governance is prescribed under the prudential regulations of Da Afghanistan Bank, the central bank of the country[109].

---

[107]Corporate Governance Code 2012, Capital Market Development Authority of Maldives
[108]Op. cit.
[109]Report on the Observance of Standards and Codes – Afghanistan 2009; The World Bank

References

Pakistan

Code of Corporate Governance (2012); Securities and Exchange Commission Pakistan

http://bluechipmag.com/code-of-corporate-governance-2012-the-secp-initiative/

http://bluechipmag.com/pakistan-corporate-governance-project/

http://telecompk.net/2007/09/04/ptcl%E2%80%99s-privatization-the-biggest-financial-scam-in-pakistan%E2%80%99s-history/

http://www.finance.gov.pk/survey/chapter_12/06-CapitalMarkets.pdf

http://www.machetemag.com/2010/12/06/pakistan-debt-crisis-of-1998-fueled-by-nuclear-power-and-political-instability/

https://www.dfat.gov.au/geo/pakistan/pakistan_brief.html

Khan, T. A., Economic viability of the Issuance of Euro-Bonds in the Perspective of Debt Crisis of Pakistan

Kwok, Kevin (2007); The Independent Director's Role: OECD Asian Corporate Governance Roundtable Conference

Tahir, S. H.; Sabir, H. M.; Arshad, A., Anwar ulHaq, M. (2012), Two-Tier Corporate Governance Model for Pakistan

The World Bank (2005) Report on the Observance of Standards and Codes – Pakistan;

Sri Lanka

http://www.heritage.org/index/country/srilanka

http://www.s-ge.com/de/filefield-private/files/2614/field_blog_public_files/1552

http://www.worldbank.org/en/country/srilanka/overview

SAFA corporate governance group: Best practices on Corporate Governance for South Asian countries (www.esafa.org_About_BP-CorporateGovernanceInSafaCountries)

Senaratne, S and Gunaratne, P. S. M. (2008) 'Corporate Governance Development in Sri Lanka: Prospects and Problems' *Conference Proceedings of Sixth International Conference on Business Management,* University of Jayewardenepure, Sri Lanka

Senaratne, Samanthi(2011) 'Corporate Governance Reforms in Sri Lanka' *Sri Lanka Journal of Advanced Social Studies* Vol 1(1)

Nepal

http://www.ekantipur.com/the-kathmandu-post/2011/03/26/money/bad-corporate-governance-major-challenge-facing-nepali-banking/219897.html

http://www.garp.org/risk-news-and-resources/risk-headlines/story.aspx?newsId=39936

http://www.thehimalayantimes.com/fullNews.php?headline=Regulatory+bodies+fail+to+enforce++corporate+governance+code&NewsID=345317

Nepal Government. 2006. Companies Act 2006. Kathmandu, Nepal: Nepal Law Commission

Pokhrel, D. R. (2007), Corporate Governance in Nepal

Regmi, U. R. (2012), Stock Market Development and Economic Growth: Empirical Evidence from Nepal; Administration and Management Review

Sharma, N. (2013), Disclosure Regime for Mandatory Disclosures by Banks and Financial Institutions in Nepal; International Journal of Accounting and Financial Reporting

Thapa, R. B. (2008), Corporate Governance: Need & Significance in Nepalese Banking System

Bangladesh

Biswas, P. K. (2012), Corporate Governance Guidelines in Bangladesh – Some Observations; *The Cost and Management*

http://www.adb.org/news/op-ed/bangladeshs-efforts-capital-market-reforms

http://www.heritage.org/index/country/bangladesh

http://www.thefinancialexpress-bd.com/old/index.php?ref=MjBfMTJfMTNfMTJfMV8yN18xNTMwMDM=

Karim, R., Sarkar, J. B., Fowzia, R. (2010); Corporate Governance Practices in Bangladesh with Reference to SEC Corporate Governance Guidelines

Karim, R., Sarkar, J. B., Fowzia, R. (2010); Corporate Governance Practices in Bangladesh with Reference to SEC Corporate Governance Guidelines

Report on the Observance of Standards and Codes – Bangladesh 2009; The World Bank

Bhutan

Bhutan State Owned Enterprises and Corporate Governance (SOE-CG) Report, January 2007 (https://openknowledge.worldbank.org/bitstream/handle/10986/12722/703380ESW0P0990n0SOE0CG0Study0Final.pdf?sequence=1)

http://www.bhutan.com/economy

http://www.kuenselonline.com/bhutan-ranked-worlds-fifth-fastest-growing-economy/#.UyQK8D-SzCc

World Bank's report on observance of standards and codes: corporate governance country assessment; Bhutan 2006 (http://www.worldbank.org/ifa/rosc_cg_bhutan.pdf)

Maldives

Corporate Governance Code (2012), Capital Market Development Authority of Maldives

http://www.heritage.org/index/country/maldives

http://www.wwwmaldives.com/maldives-business-climate.html

Afghanistan

http://www.heritage.org/index/country/afghanistan

http://www.indexmundi.com/afghanistan/economy_profile.html

The World Bank (2009) Report on the Observance of Standards and Codes – Afghanistan

9

CORPORATE GOVERNANCE IN INDIA

9.1 Genesis of Corporate Governance in India[110]

Corporate governance has evolved in India gradually through various stages from the system of management[111] by 'managing agents' around 1850 into the present model which resembles, to a large extent with the Anglo-American model. These are: The Managing Agency Model (1850-1956); The Business House Model (1956-1991); and The Post Liberalisation Model (1991 to date)

Managing Agency Model (1850 to 1956)

The model of corporate governance in India in the initial period of development was the 'managing agency' model. The model is closely identified with India. The managing agency enjoyed a predominant position in the corporate and business structure of the Indian economy for over a century from the time the joint stock company was introduced in India by the Companies Act of 1850[112]. From then on, joint stock companies and managing agency grew simultaneously till 1956 when the new Indian Companies Act, 1956 was passed which finally abolished the managing agency system in 1970.

Interestingly, the system evolved in India out of necessity. The company form of business hitherto unknown in India was introduced in 1850 and needed promoters with entrepreneurial skill, funds and linkages with both the European investors and the European market. The managing agents (who were the British agency houses doing businesses on behalf of the British merchants) promoted most of the companies, supplied the initial risk capital, and provided managerial talent which was scarce at that time. The agents also financed these companies since money and capital markets were in the rudimentary stage of evolution. The pivotal role of the managing agency system in the Indian business structure is well reflected in the fact that by 1913 it was prevalent in over 75 percent of the large scale companies in the private sector, and by 1955 the figure stood at 95 percent[113]. In fact, companies and managing agencies had a complementary existence. Managing agency playing a central governance role became the general form of corporate business in India between 1850 and 1956.

---

[110] Adopted from Anil Kumar (2012)

[111] The term 'Corporate Governance' was not known at that time, management here means structure of the top management and exercise of powers to control the company i.e. corporate governance.

[112] Before 1850, a few companies were operating in India under charters issued by the British Crown- the leading one being the East India Company

[113] Baig,1971

Managing agents initially organised themselves as partnership firms with many firms consisting of members of only one family (eg. Andrew Yule & Co.). The managing agency firms floated a number of companies, contributed a bulk of the capital and taking the rest from the investing public on the strength of their reputation. The managing agency firms served as the nucleus of corporate control in these companies, many of which did not have the board of directors. In later years, when the Companies Act, 1913 compelled the constitution of board of directors in companies, most of the directors on the boards were appointed by the managing agents from amongst its own personnel. The boards tended to be more of a fiction than reality as they were composed of friends or business associates of managing agents. Thus, 'many concerns were joint stock companies with board of directors more akin to partnership with control in the hands of the managing agents'[114].

In the initial years the managing agency system was evolved and dominated by British merchants. From the year 1920 onwards, there was a change in the scenario. Quite a few Indian businessmen established their own managing agencies. Some of the leading Indian managing agencies in the early 1930s were: Tata Sons & Co. Ltd., Cowasji Jehangir& Co. Ltd., Birla Bros. & Co., Morarji Gokuldas & Co., Nourajee Wadia& Sons. Another noticeable change in the constitution of managing agencies was a shift from partnership concerns to private limited companies and in some cases even public limited companies with the intent to take advantage of the limited liability clause under the Companies Act. This resulted into the corporate power vested in the managing agency companies which functioned like a holding company over the companies floated and managed by them.

The principal instrument of corporate control in this model was the managing agency contract. The astuteness in devising the agency contracts ensured a complete grip of the agents over the companies. Governance matters like appointment of directors on the board, investment decisions, fixing remunerations (fabulous) to themselves were the domain of the managing agents. The clauses of the contract were designed to provide for a long tenure of management irrespective of the changes in the size of their shareholding and there were provisions for heavy penalty on the companies in case of their removal from the office. All these provisions in the contract gave the agents unlimited power over the companies and ample scope to the agents for mis-governance and malpractices.

Deferred share with disproportionate voting rights was another common device during this period which enabled the managing agents to perpetuate their domination over the companies. There were cases where a mere 5 percent of the capital raised, bestowed 50 percent of the voting power in the company on the holder[115].

[114]Lokanathan, 1935: 20
[115]Basu, 1983

The agency contracts and the deferred shares became the instrument for inter-corporate investments and interlocking (multiple) directorship by which the managing agents could control large business networks. Until 1914, these networks comprised mostly trading and industrial companies. Between 1915 and 1947, a high degree of interlocking was observed between industrial companies and banks[116].

Multiple directorship or 'pluralism' of director was another mechanism through which the managing agents indulged in corporate malpractices. For example in 1927, there were instances where single individuals held directorships of as many as 65, 42 and 34 companies[117]. The few Indians nominated to boards of directors under British agents became 'stock' directors of all companies. This system of multiple directorships led to weakening of the directors' responsibilities. The role of directors was extremely limited. The board of directors became a mere ornament, a superfluity[118].

In the managing agency model the corporate power and control was neither in the hands of companies nor with the boards of directors of the companies and nor with the shareholders. Shareholders were prevented from raising their voice or participating in the affairs of the company by manoeuvring the issue of securities in small lots to investors spread over different parts of the country. This scattered distribution of shareholders disabled the possibility of their being organized. Shareholders were disinterested also in exerting any influence on the functioning of the companies. Due to the underdeveloped nature of capital markets, there was virtually no market discipline placed on them. The abuses of the agents perpetuated unbounded with the absence of government regulations[119] to curtail the excesses.

The notorious corporate governance malpractices of the managing agency system outlined by the Industrial Commission of that time[120] were the following:

(i) Investments of surplus of a profitable company in another company run by the same managing agents.

(ii) Financing capital expenditure by short-term loans.

(iii) Sub-ordination of the interests of the managed companies to those of the agents. There were reports of unholy alliances between banks and managing agents, both often under the control of the same group[121].

---

[116]Joshi, 2004
[117]Lokanathan, 1935
[118]Sengupta, 1983
[119] The companies (Amendment) Act 1936, however brought a limited control over the agents: limit of 20 yrs on the tenure of managing agents; necessity of approval of the shareholders for appointment of managing agents; limiting the number of directors to be nominated by the managing agents to 1/3rd of the total number of directors etc
[120] Quoted in Nitish Sen Gupta, p.35
[121]Lokanathan, p224-225

(iv) Unreasonable remuneration which often included commission on sales and purchases, and also office allowances. The commission included ‘unreasonable guarantee commission’.

(v) Managing agents taking up the management of more concerns than they could effectively control, for example, Andrew Yule managed 37 companies, Shaw Wallace 17, Tatas 36, Dalmias 38, Singhanias 42. In 1951, 600 industrial concerns were controlled by 36 managing agency firms[122].

(vi) Unduly long-tenure.

Thus, the economic conditions of the country at that time marked by lax government regulations, fragmented credit system and underdeveloped capital market facilitated the pre-dominance of the managing agency system which was full of governance abuses.

Business House Model (1956 to 1991)

After independence of the country, a new Companies Act, 1956 was enacted with the object of achieving a minimum standard of good behaviour and conduct by the company. It is a substantive law for corporate business in India which provides a legal framework for regulating the corporate activities including governance and administration of companies, rights of shareholders and creditors, disclosures of information relevant for stakeholders etc.

The Companies Act, 1956 closely parallels the Anglo-American model wherein a single-tier board's role is conceived to be that of governance leaving day-to-day operations of the company to the executive management. The conscious attempt of the Act is to restore the sovereignty of the board of directors in company governance which had been eclipsed in the preceding years. Section 291 of the Act, thus, states:

‘The board of directors of a company is entitled to exercise all such powers and do all such acts as the company is authorised to exercise and do.’

As a consequence of this Act, the 'managing agency' system was required to function in sub-ordination to the board and was made accountable to the shareholders. Considering their abusive style of functioning, the system was eventually abolished in 1970.

The Act also contains provisions with regard to the issues such as right of shareholders to make decisions on number of policies of the company, to appoint and remove the directors, to appoint and remove the auditors, to take recourse against corporate abuses including mismanagement of the company. The Act lays down certain disclosure norms and makes it mandatory for a company to maintain books and records. These in principle serve to protect the interest of the

[122] Mehta, 1951:p25

shareholders and bring the Indian system of corporate governance closer to the spirit of the Anglo-American model.

The corporate governance model envisaged in the Act, however, is different from the Anglo-American one in several respects. The Act subjected many corporate decisions to the approval of the government. The Central Government had assumed wide powers of intervention in large areas[123]. Some of these areas were: appointment of managing director and whole time directors in public limited companies; fixing of their terms of appointment and remuneration; inter-company investments and loans, mergers and amalgamations; inspections and investigations. This level of intervention is unparalleled in any Anglo-American system[124].

In the mixed economy model followed after the independence, the government retained most strategic industries under the public sector following the philosophy of 'commanding heights' to the State. As the private sector involvement during this period was largely dominated by family-controlled business houses, the corporate governance model of India during the period 1956 to 1991 is referred as 'Business-House' Model[125].

Most of the large business houses-- the prominent being Tata, Birla, Kirloskar, Godrej, Shriram, Mafatlal, Bajaj, Thapar, Singhania, Goenka, Dalmia, Mahindra were established after the independence had their origin in erstwhile leading managing agents. They gained strength after accumulating wealth to start-off as huge business houses. They supported and impressed the government to adopt an import-substitution policy to enable them to conduct business in a protected economic environment. Due to their financial strength they could tilt decision making in the government to their advantage. In fact, the business-houses learnt to use the government legislation in their favour.

The licensing regime fostered by the Industries (Development and Regulations) Act which became increasingly stringent (before its eventual dismantling in 1991) was the foremost barrier to private investments. It facilitated business houses in traditional sectors like textile, coal, iron and steel, and jute to secure monopolistic and oligopolistic privileges in new industries such as aluminum, paper, cement and engineering through a nexus of business houses-politicians - bureaucrats which in turn promoted widespread ‘rent seeking’[126]. Bardhan (1984) pointed out “the richer industrialists having better 'connections' and better access, have got away with the lion's share in the bureaucratic allocation of licenses, thus preempting capacity creations and sheltering oligopolistic profits.

The import- substitution policies of the government and the accompanying high import duties

[123] Most of these now have been taken out of the ambit of Central Government by making amendments in the Act in post reform era, discussed in the next section.
[124] Sengupta, 1983
[125] Mukherjee Reed (2001)
[126] Som, 2006

and tariffs resulted in markets that were highly protected and uncompetitive, thus perpetuating corporate mis governance. The astromical tax rates[127] created its own disincentives for higher private investment (Goswami, 2001). The then prevalent tax structure forced companies to cheat through undeclared cash perquisites, private expenses footed on company accounts, complicated emolument compositions, and intricate cross-holdings of shares to baffle tax calculations.

Mannerism of functioning of Indian business families was the same as was prevailing during the managing agency era as the families took over the essence of the managing agency system. Sengupta (1983) remarked that most business houses after abolition of the managing agency system readjusted their control mechanism to fit in with the new context, avoiding the expression 'manager' as also its formal appearance, but continuing the same practice of centralised control and management. Corporate control continued to remain with the controlling families who appointed themselves as managing directors or whole-time directors and appointed their family members or relatives or associates on the board of directors. A study by Baig (1971) revealed that in not less than 67 percent of the companies, the directors belonged to one family. Professor Hazari (1964) also noted that Indian corporations were dominantly family controlled.

The study of Sengupta covering the period 1969-80 reiterated the persistence of a sort of 'divine rights' of business families to continue in the control of the companies promoted by them and selecting their own replacement. The study of L C Gupta covering the period 1982-83 also drew inference that Indian companies were by and large, one man (one family) controlled. The study reported that in a sizeable proportion of listed companies, the boards of directors comprised of wholly non-executive kind[128]. In large number of companies the non-executive directors representing the dominant shareholding group would be involved even in 'day-to-day decisions', visit the office of the company like the owner (sole) of the business[129].

Indian stock market was just evolving after the independence of the country. The vacuum of under-developed stock market in providing funds was bridged by the three All India Development Financial Institutions (DFIs) - IFCI, IDBI, ICICI together with the State Financial Corporations became the substantial providers of long-term credit to companies. With the nationalisation of banks in 1969 and banking sector reforms, commercial banks also became active in providing industrial finance. The investment institutions set up by the Government such as the Unit Trust of India, Life Insurance Corporation of India and General Insurance Corporation of India invested substantial amount of their investible funds into equity capital of the companies. These changed the ownership pattern in the industry[130].

---

[127] At its peak, the corporate tax rate was as high as 55% and maximum marginal personal income-tax rate as 98.75%.

[128] L.C. Gupta's study found that out of 2007 directorship in 225 companies surveyed, the proportion of executive directors was only 15.7%.

[129] Gupta, 1989: 35

[130] DFIs entered into ownership positions by converting their loans into equities and investment institutions directly invested their funds into equities of companies.

The financial institutions (DFIs and investment institutions) could have played a big role in the governance of companies by constantly monitoring the performance of invested companies. This would have brought the governance of Indian companies closer to the bank based model of Japan and Germany. Unfortunately, this did not take place. The DFIs themselves were evaluated on the quantity rather than quality of their lending. The DFIs thus had little incentive for either proper credit appraisal or effective follow-up and monitoring. The appointment of 'nominee directors' by the public financial institutions on the boards of assisted companies became an endemic feature of corporate governance in India. Gupta's survey (1989) endorsed the pervasiveness of nominee directors system since its introduction in 1971. The survey reported[131] that over half of all listed companies and over three fourth of the larger ones among these had such nominee directors on their boards.

The presence of institutional nominees on the board of directors of companies is the most distinctive and controversial issue of the Indian corporate governance system. Gupta's study (1989) highlighted that before 1971 many companies did not observe even the basic convention of sending notice and agenda of the board's meeting. The meetings were just a legal formality to be observed lasting merely for 20 or even less than 20 minutes. The study pointed out a change in that scenario by the institution of nominee directors. But it failed to make any dent on the rubber stamp nature of the boards. Panchali (1994) accentuate the neutral stand of nominees of financial institutions in over 50 percent of take-over attempts. Chakrabarti (2005) also opined that nominee directors routinely served as rubber stamps of the management. It has been observed that nominee directors remained passive observers even in cases of misappropriation of funds or mis governance, or, when active, sided with the controlling management group.

In nut shell, the financial institutions in India, failed to fulfill even their limited role in corporate governance. In fact, with the support (passiveness) of the financial institutions, the business houses enjoyed managerial control with little equity investment (less than 20 percent on an average) of their own.

The retail shareholders entered the stock-market in 1980s with the development of capital markets in India. The retail shareholders were unorganised being scattered and were content with the annual divided. They could not exert any pressure or discipline on the business houses. The control over issue of securities (through the office of Controller of Capital Issues and the canny policy of securities allotment employed by the business houses) pre-empted formation of any dominant shareholding. The most striking feature of corporate governance in the late 1980s was that despite the small holdings, the business houses managed to control their firms, fearing neither any monitoring from public financial institutions nor any control from the shareholders (outside) nor any fear of take-over bids in the capital market. A few hostile take-overs in that

[131] L.C. Gupta's survey also examined the distribution of nominee directors. It showed that DFIs (IFCI, IDBI and ICICI) had a dominant position in operating the nominee director system being responsible for appointing 40% of all nominee directors in the companies surveyed. The state level institutions, (SIDC, SFCs) accounted for 38% of nominee directors.

period were thwarted by reputed promoters using notions of goodwill, patriotism, swadeshi etc[132].

The business houses exercised control over the companies promoted by them by forming a pyramidal structure through a holding company and appointing themselves or their family members and associates as directors. The companies in the structure were subservient to the interest of the holding company ruled by a patriarch who generally was the family head and founder of the group companies. The governance model is thus quite different from the Anglo-American one marked by separation of ownership and control.

Availability of soft loan from the public financial institutions under the garb of industrial development of the country and poor monitoring of loans dissuaded the corporate borrowers to repay the loans or run the businesses on sound principles[133]. The inevitable result was the massive default by corporates which is referred as 'Great Indian Bank Robbery'[134]. This process of default would continue till complete erosion of company's net worth and ultimately the Sick Industrial Companies Act, 1985 would declare the company as sick. L.C. Gupta reported[135] that roughly out of every six listed companies were sick at that time.

It may thus be concluded that the period of 1956-1991 saw the domination of business houses over the corporate sector with little control of the un-sophisticated illiquid stock market. Tendency of business houses in India had been to enjoy control rights disproportionately greater than their shareholding and this continued up to the late 1980s (Goswami, 2001). Government interventionist approach and public financial institutions aided the business houses to expropriate shareholders wealth (or public fund). Listing requirements and strict financial disclosure norms enforced some transparency, but non-compliance attracted nominal fines with hardly any punitive action. The minority shareholders and creditors (including DFIs and banks) remained effectively unprotected.

The Post-Liberalisation Model (1991 to Date)

The Reforms

In the wake of liberalisation and globalisation process as part of the structural adjustment programme unleashed in India in 1991, the key tenets of the Anglo-American model of corporate governance were adopted. The Indian Companies Act, 1956 which was already in line largely with the basic Anglo-American model was revamped (by making amendments) to reduce its complexity and bureaucratic interferences. The Capital Issues Control Act, 1947 was scrapped removing the control of the government over the issue of securities. The Securities and Exchange

[132] Joshi, 2004
[133] Chakrovarti, 2005
[134] Dalal S. (2002), The Great Indian Bank Robbery, *Indian Express* 01-12-2002
[135] L. C. Gupta (1981) *Rates of Returns on Equities, The Indian Experience* Delhi, p. 70

Board of India (SEBI) was set up in 1992 as an independent market regulator to bring in a new regime of greater disclosure and transparency. The gradual empowerment of the SEBI since then has played a crucial role in establishing the basic rules of corporate governance in the country.

The regulations and guidelines issued by the SEBI from time to time are aimed at achieving better governance of companies and in developing an efficient capital market. The key measures instituted by SEBI include: strict disclosure norms for public issues; strict entry criteria for public offers; automation of stock exchanges; strengthening regulations for mergers and takeovers; curbing insider trading and regulations for investments by foreign institutional investors (FIIs). The regulations enforced by the SEBI have important inferences for the governance of companies operating in India.

Since September 1992, foreign institutional investors (FIIs) were allowed to invest in the Indian securities market (debt and equity both). The Indian companies were also permitted to seek listing in international stock exchanges and raise funds abroad through Global Depository Receipts (GDRs) and American Depository Receipts (ADRs). In 1993-94, the number of Euro issues made by the Indian companies was 27 and Rs. 7897.82 crores was raised. In the same year net investments by FIIs in Indian companies was Rs. 5444.58 crores[136].

To provide a single, nation-wide market in securities, the National Stocks Exchange (NSE) was set up in 1994. To provide for scrip less trading in securities (i.e. through electronic mode), the depository system was introduced in India in 1996 by establishing National Securities Depository Limited (in 1996) and Central Depository Services (India) Limited (in 1999). Simultaneously, the Companies Act was also amended in 1997 (by inserting Section IIIA) to provide for free transferability of securities of public companies.

Liberalisation of the capital markets and free pricing of securities manifested in a boom in the stock market which is reflected in a more than four times rise in number of new issues (from 455 in 1991-92 to 1686 in 1994-95). But the boom was short-lived as the Indian stock market witnessed several scams and frauds around mid 1990s. Companies such as MS Shoes, CRB Capital Markets, Usha Rectifier, Bindal Agro, Prudential capital markets, Bindal Agro, many plantation companies made scandals through preferential issues, price rigging, exorbitant pricing of new issues, mis-utilisation of funds, accounting manipulations etc. Harshad Mehta security scam of 1992 was all time big fraud. The scams exposed the private promoters who made wind fall profits at the cost of small innumerable investors losing many millions and shied away from the capital market during the period 1995-97. Consequently new issues in the primary market drastically reduced to only 156 in 1997-98.

In that background certain measures were taken by the SEBI which included: dematerialisation and electronic transfer of securities, rolling settlements, derivative trading and greater market

[136]Handbook of Statistics of Indian Economy, 1999, RBI.

surveillance. These measures have improved the regulatory framework and efficiency of the stock markets compared to the mid1990s.

The Narasimham Committee report in November, 1991 was the turning point of the Indian banking sector. Reforms initiated such as reduction of concessional and priority sector loans, deregulation of interest rates, permitting setting up of banks in the private sector, partial divestment of government equity and public issue of shares of DFIs and nationalised banks, subjected the banking institutions to the market forces. The emphasis of DFIs and nationalised banks consequently shifted from the quantum of loans to its assessment, risk management techniques and effective mechanism to monitor the loans and bringing down the non-performing assets (NPAs). The Government tightened the law of corporate insolvency and passed an amendment Act (Recovery of Debts due to Banks and Financial Institutions) in 2000, empowering the Debt Recovery Tribunals to attach properties of defaulting borrowers. The revised norms also imposed restrictions on nominee directors. Financial institutions are now required to place nominees only on companies where their combined exposure (i.e. debt and equity) is more than Rs. 50 cr. or shareholding is more than 26 percent or in case of default on loan.

The Anglo-American model of corporate governance presupposes the existence of a strong market for corporate control. The hostile take-over and exit routes for the shareholders are the mechanisms provided for to keep the underperforming management on their toes. Indian scenario in this regard was not conducive to take-over. Till 1990s, there were few takeovers and mergers in the corporate sector of India. Legal hurdles to the mergers and acquisitions were dismantled with the introduction of free transferability of securities of public companies and SEBI's revised takeover code in 1997- SEBI (Substantial Acquisition of Shares and Takeovers) Regulations. With these the take-over activities have increased significantly from 37 take-overs in the late 1980s to 747 mergers and acquisitions in 1997-2007[137] with 104 mergers and acquisitions in the year 2005-06 alone.

Sound legal system of the Anglo-Saxon countries provides a protection to the rights of shareholders including minority shareholders. A series of research undertaken by La Porta, et al. (1998, 1999) reveals that Indian corporate governance system is very much at par with the USA and UK with respect to rights of minority shareholders particularly anti-directors rights and oppressed minority mechanism and creditors rights. The Companies (Amendment) Act, 2000 provides for postal ballot voting system for specified matters and for the appointment of directors in the board of directors of a company by small shareholders[138] (Sec. 252). Besides, shareholders can take action by suing the management and controlling group for oppression and mis-management (Sections 399 and 401 of the Companies Act). Minority shareholders are guaranteed the right to participate and vote in person or through their proxies at company

[137]From SEBI data (www.sebi.com)

[138] Small shareholder is a shareholder holding shares of nominal value of Rs. 20,000 or less.

meetings by the Companies Act which mandates the holding of Annual General Meetings. Shareholders can also apply to the SEBI for redressal of any violation of their rights. The SEBI has evolved a strict regulatory framework prohibiting fraudulent and unfair trade practices including insider trading and self-dealing. Again listed companies are required to declare their results on quarterly basis, and stronger disclosure norms for initial public offers (IPOs) have been prescribed for.

Certain positive developments in the country in the post-liberalisation period paved the way for the adoption of Indian corporate governance system on the lines of Anglo-Saxon model. Important developments include entry of multinational corporations, emergence of new breed of enterprising entrepreneurs, development of professional and management education system leading to increase in number of professionally managed companies and more discipline by the capital markets.

The Emerging Model

India undoubtedly has adopted the key tenets of the Anglo-American model of corporate governance. This was facilitated also on account of historical ties with the United Kingdom and the Indian corporate laws being based on the British company law.

Most of the recommendations of the three committees on corporate governance - the Kumar Mangalam Birla Committee (1999), Narayan Murthy Committee(2003) both set up by SEBI, and Govt. of India's Naresh Chandra Committee (2002) are remarkably similar to and have drawn inspiration from U.K's Cadbury Committee of the U.K.(1992) and Sarbanes-Oxley Act (2002) of the U.S.A.. The reforms suggested by these committees and the subsequent legislative actions taken (amendment to the Companies Act, Clause 49, revised Clause 49) have driven the Indian corporate system towards the Anglo-American model. For strengthening the board of directors (already a single tiered body), the reforms are centred on Anglo-American practice of a greater role of non-executive directors and the curtailment of multiple directorships (reduced from 20 to 15 by the Companies Amendment Act, 2000).

9.2 Regulatory Framework of Corporate Governance[139]

The corporate law in India provides a legal framework for regulation, governance and administration of companies. It has provisions regarding shareholders rights, disclosure and transparency requirements and Board’s responsibilities towards the stakeholders. The act is administered by the Ministry of Corporate Affairs and enforced by the Company Law Board and the courts. Listed companies need to comply with the guidelines of Securities and Exchange Board of India (SEBI). They are also governed by the rules of The Institute of Chartered Accountants of India, Stock Exchanges and Income Tax department. The Principal Laws and Regulations include:

[139] Adapted from Kumar, Anil and Jyotsna Rajan (2014)

- The Indian Companies Act, 2013/1956
- The Securities and Exchange Board of India Act, 1992
- The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009
- Revised Clause49 of the Listing Agreement
- The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2002
- The Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992
- The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeover) Regulations,1997
- The Securities Contracts (Regulation) Act, 1956
- The Securities Contracts (Regulation) Rules, 1957
- The Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003
- The Chartered Accountants Act, 1949
- The Foreign Exchange Management Act, 1999 and the regulations issued there under
- The Income Tax Act, 1961

9.3 Corporate Governance Regulators

Confederation of Indian Industries (CII)

CII is a pioneer institution which took the first institutional initiative towards development and promotion of a code for Corporate Governance in 1996, to be adopted and followed by the Indian Industry. This initiative by CII flowed from public concerns regarding the protection of investor interest, especially the small investor; the promotion of transparency within business and industry the need to move towards international standards in terms of disclosure of information by the corporate sector and, through all of this, to develop a high level of public confidence in business and industry. Since 1974, CII has tried to chart new path in terms of the role of an Industry Association and has gone beyond the traditional work of interacting with Government of policies and procedures which impact the industry. From time to time it has come out with recommendations for good corporate governance practices by appointing committees of prominent businessmen who understand the problems of mis-governance from the very root level and understand the relevance of corporate governance practices for survival and growth in the competitive world.

Securities and Exchange Board of India (SEBI)

The SEBI regulates the stock exchanges, stock brokers, share transfer agents, merchant banks, portfolio managers, other market intermediaries, collective investment schemes and primary issues. Since it’s a stock market regulator, its major role is investor protection. SEBI has come

out with various regulations since its inception including those on prevention of Insider Trading, fraudulent trade practices, Takeovers etc. mainly for listed companies. In view of several malpractices and bad governance being pursued by a large number of companies, a need was felt to move towards a statutory rather than a voluntary code, at least in respect of essential features of corporate governance. So, SEBI came out with statutes for corporate governance. SEBI appointed Kumar Manglam Birla committee for guidelines on corporate governance which were on the basis of Cadbury Committee report in England.

The introspection that followed the Satyam episode has resulted in some major changes in Indian corporate governance regime, some of which include peer review exercise of working papers of companies constituting NSE and BSE Sensex; making mandatory for all listed companies to have a well maintained website; revision in the Clause 49, compulsory dematerialization of promoter's holding; mandatory disclosure of pledged shares held by promoters; disclosure of voting results etc.

SEBI has been actively participating in the OECD Asian Roundtable Conferences and in Corporate Governance Committee and sub-committee meetings as observers. SEBI and OECD have entered into bi-lateral co-operation agreement in the area of Corporate Governance.

Ministry of Corporate Affairs (MCA) [11.]

Ministry of Corporate Affairs , earlier known as Department of Corporate Affairs under Ministry of Finance, is primarily concerned with the administration of the Companies Act, 1956, and other allied Acts, etc. framed there-under for regulating the functioning of the corporate sector in accordance with the law. It is also responsible for administering the Competition Act, 2002 and exercises supervision over the three professional bodies, namely, Institute of Chartered Accountants of India (ICAI), Institute of Company Secretaries of India (ICSI) and Institute of Cost and Works Accountants of India (ICWAI), which have been constituted for proper and orderly growth of the professions concerned.

Ministry of Corporate Affairs has set up **a National Foundation for Corporate Governance (NFCG)** in association with CII, ICAI and ICSI, as a not-for-profit trust. It provides a platform to deliberate on issues relating to good corporate governance, to sensitise corporate leaders on importance of good corporate governance practices as well as facilitate exchange of experiences and ideas amongst corporate leaders, policy makers, regulators, law enforcing agencies and non-government organizations.

The NFCG has a three-tier structure for its management, viz, the Governing Council under the Chairmanship of Minister of Corporate Affairs, the Board of Trustees and the Executive Directorate.

NFCG had framed an action plan, which includes development of good corporate governance principles on identified themes i.e. (i) corporate governance norms for institutional investors, (ii) corporate governance norms for independent directors, and (iii) corporate governance norms for audit.

The foundation has been set up with the mission to:

- foster a culture for promoting good governance, voluntary compliance and facilitate effective participation of different stakeholders;
- create a framework of best practices, structure, processes and ethics;
- make significant difference to Indian corporate sector by raising the standard of corporate governance in India towards achieving stability and growth.

9.4 Major Regulations on Corporate Governance

Clause 49 of the Listing Agreement:

Clause 49 of Listing Agreements contains provisions on corporate governance to be complied with by all companies listed at the Indian stock exchange. Its main recommendations are:

• **Board Independence**: Boards of directors of listed companies must have a minimum number of independent directors. Where the Chairman is an executive or a promoter or related to a promoter or a senior official, then at least one-half the board should independent directors should constitute at least one-third of the board size.
• **Audit Committees:** Listed companies must have audit committees of the board with a minimum of three directors, two-thirds of whom must be independent. In addition, the roles and responsibilities of the audit committee are to be specified in detail.
• **Disclosure:** Listed companies must periodically make various disclosures regarding financial and other matters to ensure transparency.
• **CEO/CFO certification of internal controls:** The CEO and CFO of listed companies must
(a) certify that the financial statements are fair and
(b) accept responsibility for internal controls.
• **Annual Reports**: Annual reports of listed companies must carry status reports about compliance with corporate governance norms.

The Companies Act, 2013

The Act is made fully effective from April 1, 2014. It is replacing the old Companies Act, 1956 and makes comprehensive provisions concerning corporate governance in the country.It contains 470 Sections 29 Chapters & 7 schedules as against 658 Sections 13 parts and 15 schedules in the

old Act. Main provisions of the Companies Act, 2013 impacting corporate governance system are:

Disclosure of Promoters' Holding (Section 93): Every listed company shall file a return in the prescribed form with the registrar with respect to change in the number of shares held by promoters and top ten shareholders, within 15 days of such change.

National Financial Reporting Authority (Section 132): Establishment of NFRA by central government for recommending formulation of accounting policies and standards, monitoring and enforcing their compliance. It can also be granted powers by central government to investigate into matters of professional and other misconducts by professionals including chartered accountants, cost accountants or company secretaries.

Corporate Social Responsibility (Section 135): Every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a Corporate Social Responsibility Committee of the Board consisting of three or more directors, out of which at least one director shall be an Independent director. It will be Board's responsibility to approve CSR policy for the company, disclose it in Annual Report and ensure that the company spends, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years.

Audit and Auditors:

Appointment and Rotation (Section 139): A listed or any other prescribed class of company cannot appoint an individual as an auditor for more than one term of five consecutive years; and an audit firm as auditor for more than two consecutive terms of five years each, provided that such auditor shall not be eligible for re-appointment as auditor in the same company for five years from completion of his term.

*Prohibition of non-audit services (Section 144):*An auditor shall provide only those services as are approved by the Board or the audit committee, but it shall not include services like: Accounting and book-keeping; Internal audit; Acturial services; Design and implementation of financial information system; Investment advisory; Investment banking; management services; Outsourced financial services; and any other prescribed services.

Appointment and Qualifications of Directors: The maximum number of directors in the company has been increased from 12 to 15. To increase it further, only shareholder approval is required.

- Maximum No. of Directorship increased from 15 to 20. But private companies also included in this limit.

- Independent Directorship limited to 2 companies only. Its tenure is set up to five consecutive years.
- One Woman Director becomes compulsory for listed and other companies with paid up capital of rupees 100 crores or more.

Prohibition on Forward Trading: It restraints the directors or key managerial personnel of the company from indulging into forward trading of shares or debentures of the company, or its holding or subsidiary or associate company.

Insider Trading (Section 195): It defines 'Insider Trading and 'Price-sensitive information' and specifies the punishment for any person involved in Insider trading.

Class Action (Section 245): This would give powers to a group of members or depositors, if they think that management or conduct of affairs of company are conducted in a way that is prejudicial to the interests of company, to file an application before the Tribunal on behalf of all members or depositors to restrain the company from such action.

Special Courts (Section 435): National Company Law Tribunal and National Company Law Appellate Tribunal becomes reality.

Other Provisions:

- Commencement of Business compulsory even for private company.
- Financial year flexibility done away with.
- Secretarial audit been made mandatory for every listed companies and other companies belonging to such classes as prescribed.
- Select Secretarial Standards issued by ICSI becomes mandatory.
- Length of the Notice of BM now prescribed.
- Consolidated Financial Statements is compulsory now.

9.5 Corporate Governance Practices in India[140]

Corporate governance practices in India show a marked improvement over the years in areas like board structure and processes, disclosure, and redressal of investor grievances. This has come about partly as a result of strengthening of the regulatory framework through a series of legal and regulatory measures initiated in the 1990s, and partly out of the desire of the companies to benchmark corporate governance practices to attract foreign capital. There is also increasing recognition that good corporate governance practices lead to higher investors' confidence and that the market take notice of well-governed companies.

[140]Adopted from Anil Kumar (2012) *Corporate Governance: Theory and Practice* .International Book House, New Delhi

The key elements of governance practices of the companies operating in the private sector of the country are summarized below:

Philosophy and Key Objectives of Corporate Governance

In the Anglo-Saxon countries- the US, the UK, Australia and Canada- the primary corporate objective is maximizing the shareholders' value, although there is a growing recognition to address the other stakeholders' interest to maximize shareholder value over the long term. The Narayana Murthy Committee also affirms the aim of 'good corporate governance' as enhancement of long-term value for its shareholders and all other partners. The key objective of good corporate governance of most of the companies in India as stated in their philosophy statements is enhancement of long-term shareholders' value keeping in view the interest of other stakeholders. Some cases in point are:

"………Corporate Governance at Arvind means being responsive to aspirations of all the stakeholders - customers, suppliers, lenders, employees, the shareholders and expectations of the society." Arvind Mills Limited

"………commitment to achieve a balance between Stakeholder's Interest and Corporate Goals through the efficient conduct of its business guided by transparency, accountability and integrity……" Escorts Limited

A few companies in India explicitly recognize the need to protect the interest of minority shareholders in their statement on the philosophy of corporate governance. This has in fact been a major area of concern in India as most governance issues in India concern principal-principal conflict arising out of dominant shareholding by the promoters. Cases are:

"……. endeavor to enhance long-term shareholder value and respect minority rights in all our business decisions."

Infosys Technologies Limited

"……Corporate Governance rests upon the four pillars of transparency, full disclosure, independent monitoring and fairness to all, especially to minority shareholders."

Hero Motor Limited

"…….governance philosophy rests on five basic tenets, viz., Board accountability to the Company and shareholders, strategic guidance and effective monitoring by the Board, protection of minority interests and rights, equitable treatment of all shareholders as well as superior transparency and timely disclosure……."

Aditya Birla Nuvo Limited

There are companies in India which subscribe to the ‘triple bottom line’ philosophy of the King Report II of South Africa embracing the economic, social and environmental aspects of company’s activities. Some examples are:

“……… Corporate Governance has been an integral part of the way we have been doing our business since inception. We believe that good Corporate Governance emerges from the application of the best and sound management practices and compliance with the law coupled with adherence to the highest standards of transparency and business ethics. These main drivers, together with the Company's ongoing contributions to the local communities through meaningful Corporate Social Responsibility initiatives will play a pivotal role in fulfilling our vision to be the most admired and competitive company in our industry and our mission to create value for all our stakeholders.

The Company places great emphasis on values such as empowerment and integrity of its employees, safety of the employees & communities surrounding our plants, transparency in decision making process, fair & ethical dealings with all, pollution free clean environment and last but not the least, accountability to all the stakeholders. These practices being followed since the inception have contributed to the Company's sustained growth. The Company also believes that its operations should ensure that the precious natural resources are utilized in a manner that contributes to the 'Triple Bottom Line'.”
Ambuja Cement Limited

“…….Since large corporations employ a vast quantum of societal resources, ITC believes that the governance process should ensure that these resources are utilised in a manner that meets stakeholders' aspirations and societal expectations. This belief is reflected in the Company's deep commitment to contribute to the 'triple bottom line', namely the development, nurture and regeneration of the nation's economic, social and environmental capital.
I T C Limited

The main thrust of company’s philosophy of corporate governance is on transparency, fairness, disclosure and accountability. This is evident from the philosophy statements of the companies given as under:

“……Transparency, fairness, disclosure and accountability are the main thrust to the working of the Bajaj Group. Bajaj Auto Limited maintains the same tradition and commitment……..”
Bajaj Auto Ltd.

“Dr. Reddy's Laboratories Limited has a philosophy of corporate governance which stems from the belief that timely disclosures, transparent accounting policies and a strong & Independent Board go a long way to preserving shareholders trust while maximizing long-term corporate value.”

Dr. Reddy’s Laboratories Limited

Role of the Board of Directors

In India, the Companies Act 2013 lays down the role of the board as that of governance. Section 179 of the Act, thus states that the board of directors of a company is entitled to exercise all such powers and do all such acts as the company is authorized to exercise and do. However, the corporate practices have been contrary to the legal mandate. In many companies belonging to the 'industrial families', the role of the board had been eclipsed either by the holding company of the group or by the priorities and preferences of the founding chairman of the company. The study of Sengupta (1983) covering the period 1969-80 reiterated the persistence of a sort of 'divine rights' of business families to continue in the control and selecting their own replacement. Gupta's study covering the period 1982-83 also drew inference that Indian companies were by and large, one man (one family) controlled. The study reported that in a sizeable proportion of listed companies, the boards of directors comprised of wholly non-executive kind. In large number of companies, Gupta further found that the non-executive director, representing the dominant shareholding group would be involved even in 'day-to-day decisions', visits the office of the company like the owner (sole) of the business[141]. The board meetings used to be a mere formality without any structured agenda lasting for not more than fifteen minutes.

The regulations of the SEBI including the SEBI Code and the growing recognition to adopt the 'good corporate governance practices' has brought out a change in positioning the board to its rightful sphere. The Kumar Mangalam Birla Committee noted, "The pivotal role in any system of corporate governance is performed by the board of directors. It is accountable to the stakeholders and directs and controls the Management. It stewards the company, sets its strategic aim and financial goals and oversees their implementation, puts in place adequate internal controls and periodically reports the activities and progress of the company in the company in a transparent manner to the stakeholders[142]. Further, "the board of a company provides leadership and strategic guidance, objective judgement independent of management to the company and exercises control over the company, while remaining at all times accountable to the shareholders. The measure of the board is not simply whether it fulfills the legal requirements but more importantly, the board's attitude and the manner it translates its awareness and understanding of its responsibilities. An effective corporate governance system is one, which allows the board to perform these dual functions efficiently. The board of directors of a company thus directs and controls the management of a company and is accountable to the shareholders[143].

Some listed companies in India follow a practice of disclosing the information provided to the board in their Annual Reports. The cases in point are:

[141]Gupta, 1989: 35
[142]Report of the Kumar Mangalam Birla Committee on Corporate Governance. 1999: 2.8
[143]Report of the Kumar Mangalam Birla Committee on Corporate Governance. 1999: 6.1

Case Dabur India

Information Supplied to the Board:

The Board has complete access to all information with the Company. All Board meetings are governed by a structured agenda which is backed by comprehensive background information. Inter-alia, the following information is regularly provided to the Board, as part of the agenda papers well in advance of the Board meetings, or is tabled in the course of the Board meeting.

* Detailed Business Review.
* Annual operating plans and budgets and any update thereof.
* Capital budgets and any updates thereof.
* Quarterly results for the Company and its operating divisions and business segments.
* Minutes of the meetings of the Audit Committee and other committees of the Board.
* Information on recruitment and remuneration of senior officers just below the level of Board, including the appointment or removal of Chief Financial Officer and Company Secretary.
* Materially important show cause, demand, prosecution notices and penalty notices.
* Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.
* Any material default in financial obligations to and by the Company, or substantial non-payment for goods sold by the Company.
* Any issue, which involves possible public or product liability claims of substantial nature, including any judgement or order which may have passed strictures on the conduct of the Company or taken an adverse view regarding another enterprise that can have negative implications on the Company.
* Details of any joint venture or collaboration agreement.
* Transactions that involve substantial payment towards goodwill, brand equity or intellectual property and any other acquisition.
* Significant labour problems and their proposed solutions. Any significant development on Human Resources / Industrial Relations front, like signing of wage agreement, implementation of voluntary retirement scheme, etc.
* Sale of material nature, of investments, subsidiaries, assets, which is not in the normal course of business.
* Quarterly details of foreign exchange exposures and steps taken by the Management to limit the risks of adverse exchange rate movement, if material.
* Non-compliance of any regulatory, statutory nature or listing requirements and shareholders' service, such as non-payment of dividend, delay in share transfer, etc.
* Details of investment of surplus funds available with the Company.
* Minutes of the Board Meetings of the subsidiary companies.
* Statement showing significant transactions and arrangements entered into by the subsidiary companies.

* Details of any merger or demerger actions.
* Details of dealings in company's share by members of board/ senior management.
* Details of commercial dealings by firms/ companies in which members of the board/ senior management or their relatives hold shares with the company.
* Details of Inter Corporate Loans, Investments and Guarantees made/ given by the Company.
* Detailed status on the Business Risks being faced by the Company and their mitigation plan.
* Changes in Shareholding Pattern of the Company.
* Details of transactions with Related Parties.

The Board has established procedures to enable the Board to periodically review compliance reports of all laws applicable to the Company, prepared by the Company, as well as steps taken by the Company to rectify instances of non-compliance.

While some companies provide the detailed information in advance as part of the agenda papers, some other companies supplement the agenda papers by way of presentations and discussion material during the meeting. The role of board of directors of most companies in India is, however, different from what is proclaimed. Surveys on corporate governance conducted by Bain & Co. and KPMG in 2009 report that boards of most companies including the top ones, fail to keep up with the evolving standards in corporate governance. They have little understanding of the business of the companies they govern. They never get the right information before the board meeting and usually contribute to decision making informally. Further, their involvement in CEO succession planning is very limited or non-existent. One glaring example of the limited role of the boards is provided by the battle of control and division in Reliance Industries between the Ambani brothers. The board of directors' role in settling the dispute was non-existence. The board didn't realize its fiduciary role to protect the interest of at least other shareholders holding more than 60 percent shares in the company. The recent imbroglio in SKS Microfinance culminating in the ouster of Mr. Suresh Gurumani -the CEO of the company who steered the company through a successful IPO in 2010 raises the question of failure of the board in not managing the relationship between the founder and the professional CEO.

Board Meeting Frequency

Number of meetings of board of directors of a company is an indicator of boards' efforts in discharging its role and its involvement in the effective governance of the company. While most codes of best practice world over lay down that the board should meet sufficiently regularly to discharge its responsibilities effectively (for example, Cadbury Code, Combined Code of the UK, the Malaysian Code), Section 285 of the Indian Companies Act, 1956 and also the Clause 49 require a company to hold at least 4 board meetings in a year with a gap of not more than 3 months between the two consecutive meetings.

The study on corporate governance practices of the top 100 BSE companies [144] from the year 2001 to 2010 reveals that while the median number of board meetings is 6, the average number of board meetings has come down to 6.21 meetings in 2010 from 6.72 in 2001. As depicted by Table 11.1, a few companies hold 4 board meetings in a year and the number of such companies is showing an increasing trend from merely 5 companies in 2001 to 11 companies in 2010. This meets the statutory requirement but one would expect at least 5 board meetings in a year-- 4 meetings for the adoption of quarterly accounts and one meeting to coincide with the Annual General Meeting. In fact, an overwhelming majority of companies (68 percent) follow a practice of 5 to 7 board meetings in a year.

A few outliers are: Silverline Technology Limited had 18 board meetings in 2001; NIIT Limited had 15 board meetings in 2001; 11 board meetings in case of L & T Limited, Tata Steel and Colgate Palmolive in 2005; Tata Motors and Videocon Limited had 11 board meetings in the year 2009-2010.

Table 9.1:Number of Meetings of Board of Directors in Companies

Number of Meetings in a Year	**2001**	**2005**	**2010**
4	5	8	11
5-7	57	55	54
8-10	6	3	4
More than 10	6	3	4
Total Number of Companies	80	80	80
Average Number of Meetings	6.72	6.4	6.21
Median Number of Meetings	6	6	6
Minimum Number of Meetings	4	4	4
Maximum Number of Meetings	18	11	14

(Source: Author's estimation based on corporate governance reports of top 100 companies)

Generally, boards meetings are held in the corporate offices of the companies. It is a good practice by some companies to hold the board meetings at the plants. A few companies hold the boards' meetings at different locations. For example, the board of Amara Raja Batteries met in Shanghai also in 2010 (Annual Report, 2010). A positive trend observed is that some companies organize annual board retreat in addition to regular board meetings to have a focused discussion on strategic issues.

Board Size

With the statutory requirement of minimum three directors on the boards of public companies, the size of the boards of typically family managed companies in India used to be constrained by

[144] excluding public sector companies and the Banking companies which reduced the number of companies to 80

the compulsions to accommodate family members and associates. Another important factor was the presence of 'nominees directors' appointed on the boards of assisted companies by the financial institutions. For example, in 2001 the number of nominee directors was as high as 4 in case of Apollo Tyres and India Cement Ltd. and 3 in many companies including Ballarpur Industries and Tata Chemicals to name a few companies. With the Statutory Code of Corporate Governance (Clause 49), the board size has become more important an issue as the requirement of non-executive directors and independent directors on the boards of a company is linked with the total number of directors. There has also been a change in the practice of appointing 'nominees directors' by the financial institutions brought out by the new guidelines of appointing nominees in companies where the combined (debt and equity) exposure of the concerned institution exceeds Rs. 500 million or shareholding surpasses 26 percent.

The study of corporate governance practices of top 100 BSE companies conducted by the author shows that the average board size of the companies in the sample has reduced from 10.74 in 2001 to 9.85 in 2005 ostensibly to meet the stricter criteria of independent director introduced from 2005. The average size of board increased marginally in 2010 to 9.88. The median board size remained unchanged at 12 in 2001 as well in 2005 and 2010. As depicted by Table 11.2, large majority of companies had between 8 and 12 board members. Only one company had a board size of 5 in 2001. Surprisingly, the number of companies having 4 or 5 board members increased to 6 in 2010. A few companies with large board sizes in the year 2001 were-- Tata Steel (16), Nicholas Piramal now Piramal Healthcare (15), ACC (16), AppolloTyres (14); in 2005- Hero Honda (16), L&T (15), Infosys (15), AppolloTyres (15), Tata Tea (14); and in 2010- Bharti Airtel (16), Hero Honda (16), Bajaj Auto (16), and ITC (15).

Table 9.2: Size of Board of Directors of Companies in India

Board Size	2001	2005	2010
Up to 5	1	3	6
6-8	19	23	23
9-10	22	21	18
11 and More	38	33	33
Total Companies	80	80	80
Mean Board Size	10.74	9.85	9.89
Median Board Size	10	10	10
Mode Board Size	9	9	12

Source: Author's estimation based on corporate governance reports of top 100 companies

Board Composition

Composition of boards of directors has undergone a rapid transformation worldwide following the publication of corporate governance guidelines and codes of best practice which call for a majority of the board to be comprised of independent directors.

In India, the SEBI Code (2000) initially left the criteria of determination of ‘independent director’ to the board of directors on the lines of the practice elsewhere. Clause 49 thus provided ‘‘'Independent directors' mean directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgement of the board may affect independence of judgement of the director”. Later, on the recommendations of the Naresh Chandra Committee and the Narayana Murthy Committee, the revised SEBI Code (revised Clause 49) laid down stricter qualification criteria for independent director.

Defining independent director particularly tightening the ‘loopholes’ is an issue which confronted opposition from the corporate sector and forced the SEBI to extend the deadline for implementation of the revised Code. Excuses such as dearth of independent directors, hardship to the companies in getting the independent directors etc. were made by the companies and their representing bodies. But there are companies like Infosys which not only has been meeting the SEBI criteria of independent directors but has adopted the definition which is in line with the best practices.

Board Composition Practices

Traditionally Indian companies were by and large one family controlled and in a sizeable proportion of listed companies, the board of directors comprised of wholly non-executive directors. As per the Gupta’s study covering the period 1982-83, the proportion of executive directors was only 15.7 percent out of 2007 directorships in 225 companies surveyed. The study of Kapur (1991) also pointed out that in over 50 percent of companies, the proportion of executive directors to total directors ranged between 10-30 percent. This was owing to the compulsion of families controlling many companies. ‘A family firm moving into the second generation may find that, whilst some family members continue to be directly involved in the management of the firm, others are now outside the firm and shareholders only. Calls for non-executive directors to represent the non-management family shareholders on the board may now arise’[145]. In India, the nominees of promoters as non-executive directors continued to wield considerable power over the companies since the managing agency days. This was the typical corporate governance practice in India until the implementation of the statutory SEBI Code in 2001.

Board composition assumed importance in India with the introduction of the corporate governance code in 2001 on a mandatory basis by the SEBI. The trend of board composition[146] shows that Indian boards are still dominated by the non-executive directors. The average proportion of non-executive directors was 73 percent in 2001, 74 percent in 2005, and 75 percent in 2010. The median proportion stood at 75 percent through all these years. Further, as depicted by Table 9.3, nearly 50 percent of companies in the study had 75 percent or more proportion of

[145]Tricker, 2009
[146] on the basis of the study undertaken by the author

non-executive directors in 2010, and in the same year nearly 50 percent of companies had proportion of non-executive directors in the range of 51-75 percent. More interesting is that in 2001 and also in 2005, a few companies had the boards consisting entirely of non-executive directors. Some companies follow a practice of the board consisting of a Managing Director or CEO and all other directors being non-executive directors. Prominent among these are: Britania Industries, Century Textiles, Crompton Greaves, Cummins India, Grasim Industries, Aditya Birla Nuvo, Hindalco, Gujrat Gas, Ambuja Cement, Madras Cement, Novatis, Tata Elxi, Titan Industries, Silverline Technology, Trent Ltd., Voltas Ltd.

The desirable and the best practice is to have a board with an optimum combination of executive and non-executive directors which is laid down by many codes of best practice worldwide including the SEBI Code. The role of executive directors in the board processes should not be undermined as they provide the board with greater knowledge and technical skills about the company.

Table 9.3: Proportion of Non-Executive Directors in Companies

Percentage of NED	**% of Companies in 2001**	**% of Companies in 2005**	**% of Companies in 2010**
Up to 50	7.5	2.5	3.75
51-75	52.5	57.5	48.75
76 and More	40	40	47.5
Mean Percentage of NED	**0.73**	**0.74**	**0.75**
Median Percentage of NED	**0.73**	**0.75**	**0.75**

Source: Author's estimation based on corporate governance reports of top 100 companies

Independent Directors: Practices in India

Indian companies began to induct independent directors on their board from the year 2000-01 largely to meet the requirements of the mandatory provisions of the statutory code. Although, a few companies such as Infosys, Nicholas Piramal (now Piramal Healthcare), Atlas Copco took a lead in this direction before the year 2000 following the publication of CII Code in the year 1999. Despite voluntary, the CII Code was responded to by 30 large listed companies accounting for over 25 percent of India's market capitalization[147]. Those companies not only adopted the recommendation of CII on the proportion of independent directors on the boards but other recommendations of the Code also.

[147] Goswami, 2001

So far compliance of Clause 49 in respect of board composition, it has been satisfactory. As per the report of the SEBI Committee (Narayan Murthy Committee Report, 2003), 54 percent of the total 1848 BSE companies had the mandatory proportion of independent directors in their boards in the year 2002. The study undertaken on the top 100 companies in India (by the author) through the years 2001 to 2010 reveals that only 6 companies were not complying with the independent directors requirement in 2001, and just 5 companies were in the non-compliant category in 2005.

More important, however is the practice adopted by the companies in India which indicates 'ticking the box' exercise in most cases. The first version of the SEBI Code (i.e. the original Clause 49) adopted a liberal definition of 'independent director' and left considerable scope of discretion to managements of the companies (technically to the board of directors). Most companies took the full advantage of the provision by inducting past employees and partners of consulting firms as 'independent directors'. In quite a few other cases, the appointment of 'independent directors' was made as additional director just one to two months before the date for which compliance report was to be submitted. In some instances, a person acting as executive director since long was shown as 'independent director' immediately to meet the deadline of March 2001. Some of the companies which had executive chairman (who happened to be the promoter of the company) became non-executive chairman over-night ostensibly to deflate the 50 percent requirement of independent directors to 33 percent. The intention of the regulator in linking the status of the chairman to the component of independent directors was certainly different from the practice adopted by the companies.

This is not something which is unique to the Indian scenario. In South Korea, for example, when the listed Korean companies were asked to have one fourth of the board consisting of independent directors, the retired executives of the *Chaebols*, friends of business groups and politicians who were supporters of the *Chaebols* were tagged as 'independent directors'.

The revised SEBI Code with effect from 01.01.2006 has tightened the definition of 'independent director' by introducing a more stringent checklist of verifiable set of seven criteria of professional, financial and familial ties of a director with the company (see Box). The new stipulation has also plugged the power of the board in judging 'independence' of the director. With transitional problems initially, the companies have adjusted to the new stipulation. The compliance rate as in the past is far above satisfaction. At the end of the year 2007, out of the total 1327 companies listed at the National Stock Exchange, 98 percent were in compliance with the corporate governance requirement[148]. Likewise, a large number of the companies listed at the Bombay Stock Exchange were adhering to the revised Clause 49 concerning corporate governance. The study of top 100 companies relating to the year 2010 also shows that all the companies in the sample had requisite proportion of independent directors in their boards. Table

[148] As per the statement made by Mr. Ravi Narain (Managing Director, NSE), published in The Hindustan Times, dated 13.12.2007

9.4 presents the distribution of percentage of independent directors in the years 2001, 2005, and 2010. 95 percent of companies had proportion of independent directors in the range of 34-75 percent which is a marked improvement over 2001 and 2005. The average proportion of independent directors in the top 100 companies for which data is available has also increased from 53 percent in 2001 to 56 percent in 2010.

Table 9.4:Proportion of Independent Directors in Companies

Percentage of Independent Directors	% of Companies 2001	% of Companies 2005	% of Companies 2010
Up to 33	12.5	13.75	1.25
34-50	43.75	37.5	48.75
51-75	35	43.75	46.25
76 and above	8.75	5	3.75
Average Percentage of Independent Directors	53	52	56
Median Percentage of Independent Directors	50	50	51.5

Source: Author's estimation based on corporate governance reports of top 100 companies

The trend over the last 10 years in the board of directors of the Indian companies points to a rise in the proportion of the 'independent' directors. Although, the practice in this regard in many cases ponder whether such directors are really independent from the promoters or the group controlling the companies. Long-time friends and associates of the business houses (who otherwise meet the criteria of 'independence') are still shown as independent directors in the companies controlled by the business houses.

Lead Independent Director

Designating a lead independent director and separate meetings of the independent directors are best of the international practice. The codes of corporate governance in India including the guidelines issued by the Ministry of Corporate Affairs in 2009 are silent on the issue. Nonetheless a few companies in India have not only appointed a lead independent director but deliberated on the role of such a director. Some examples are:

Case I: Bharti Airtel

Since Bashir Currimjee would retire w.e.f. the conclusion of the board meeting dated April 28, 2010, Mr. N. Kumar has been designated as lead independent director in his place w.e.f. April 28, 2010. In addition to the roles and responsibilities of an independent director, the lead independent director is entrusted with the following responsibilities:

* Preside over all deliberation sessions of the independent directors;
* Provide objective feedback of the independent directors as a group to the Board on various

matters including agenda and other matters relating to the Company;
* Undertake such other assignments, as may be requested by the Board from time to time.

The company follows the practice of separate meetings of the independent directors:

"All independent directors meet separately prior to the commencement of every board meeting, on their own, (without the presence of any non-independent/executive directors or representatives of management) to discuss and form an independent opinion on the agenda items and other board related matters. The independent directors also meet internal and statutory auditors periodically without the presence of management to ensure their independence and proper discharge of duties by them."

Case II: Infosys Technologies Limited

Lead Independent Director:

Prof. Marti G. Subrahmanyam is a Lead Independent Director.

He represents and acts as spokesperson for the independent directors as a group, and is responsible for the following activities:

* Presiding over all executive sessions of the Board's independent directors.
* Working closely with the Chairman and the CEO to finalize the information flow, meeting agendas and meeting schedules.

* Liaising with the Chairman, CEO and the independent directors on the Board.
* Taking the lead role, along with the Chairman in the Board evaluation process.

Discussion with independent directors:
The Board's policy is to regularly have separate meetings with independent directors to update them on all business-related issues and new initiatives. In such meetings, the executive directors and other members of the senior management make presentations on relevant issues. In addition, our independent directors meet periodically in an executive session that is without the Chairperson, or any of the executive directors, or the Management.

(Source: Annual Reports of the Companies for the year 2009-10)

Nomination of Independent Director

Who appoints the independent director? How or on what basis the appointment of independent director is made? These may have a bearing on the independence of the person appointed. Right to appoint the directors, legally speaking is the domain of the shareholders. When this power is usurped by a few individual shareholders or the CEO of the company, the institution of independent director becomes suspect and the board becomes a cozy club. Nominating committee as a sub-committee of the board consisting of majority of independent directors is

designed to be a check and balance mechanism to reduce the possibility of a dominant group or individual such as company chairman or CEO nominating their own candidates on the basis of their personal connection.

The corporate sector in India is dominated by the 'business houses' with shareholding above 45 percent (on average). In such a situation, controlling family groups /promoters nominate all the board members. The directors (independent) have to depend on the controlling groups for being re-nominated to the board. The fact of the matter is that they are re-nominated again and again unless found 'inconvenient'. How can such directors be 'independent of management' to air their independent opinions on matters affecting long term shareholders value which are otherwise in conflict with the interest of the controlling group? The Corporate Governance Code in India leaves the selection of directors to the discretion of the controlling groups whose behaviour the board is supposed to monitor. Som (2006) also opine that majority of companies in the Indian private sector do not have 'independent directors' in a meaningful way and in most cases they choose not to exercise their independence. Naresh Chandra Committee (2003) also observed that the promoters usually pack the board of directors with their cronies. This phenomenon is discernible right from the days of managing agency. The lack of a structured approach in nominating independent directors is a major negative aspect of corporate governance practice in India. The Companies Act 2013 and the revised Clause 49 require companies to constitute nomination and remuneration committees and to select independent directors from a pool to be announced by the government. It should have a positive impact on having the appropriate kinds of directors on the boards of companies.

Induction, Training, and Development of Directors

In India, the Naresh Chandra Committee (2002) while acknowledging that non-executive directors should be aware of their rights, responsibilities and liabilities, recommended that all independent directors should be required to attend at least one training course before assuming responsibilities as an independent director. The Committee went to the extent of disqualifying an untrained independent director (Recommendation 4.11). The Narayana Murthy Committee (2003) included the issue of training under the 'non-mandatory' category of recommendation. Corporate Governance Voluntary Guidelines (2009) issued by the Ministry of Corporate Affairs, recommends that 'the companies should ensure that directors are inducted through a suitable familiarization process covering, inter-alia, their roles, responsibilities and liabilities. Efforts should be made to ensure that every director has the ability to understand basic financial statements and information and related documents/papers'.

In India, quite a few organizations in both government and non-government sectors conduct programmes for director training and development. National Foundation for Corporate Governance (NFCG) has been established by the Ministry of Corporate Affairs in partnership with CII, ICSI, ICAI, ICWAI and NSE to function as the National Apex platform for promotion

of good Corporate Governance (CG) practices in India. NFCG provides financial grant to Accredited Institutions for conducting awareness programmes on good CG practices, providing quality training to Directors / Faculty as well as conducting quality research in the area of CG. Institute of Directors (IOD), an apex organization of company directors in India, is committed to upgrading the professional competence of its directors and enhancing the competitiveness of Indian business. It provides the most powerful platform to network Company Directors with movers and shakers of India. The programmes of IOD include monthly lectures, tutorials-cum-workshops through internationally acclaimed experts at major industrial centers, national and international conferences. Professional bodies such as Institute of Company Secretary of India, Institute of Chartered Accountants of India; premier management institutes of the country such as Indian Institute of Management ; and apex industry associations-- CII, FICCI, and ASSOCHAM-organize workshops and conferences from time to time to enhance professional development of directors of companies. Most of the companies in India encourage their directors to participate in such programmes either in their personal capacity or sponsored by the companies.

A very few companies have structured training programmes for their directors as in most companies directors are associated with the companies for a long time. Continuous development of directors through education and training is missing ingredient of corporate practices in India. This is partly because most of the independent directors are the senior retired executives or professionally qualified persons active in their professional activities also, need for imparting training to them is seldom felt.

Practices followed by a few of the top 100 companies as discernible from their annual reports (2009-10) are as follows:

Asian Paints

The Managing Director & CEO and other senior management personnel of the Company make presentations to the Board Members on a periodical basis, briefing them on the operations of the Company, plans, strategy, risks involved, new initiatives, etc. and seek their opinions and suggestions on the same. Also, the Directors are briefed on their specific responsibilities and duties that may arise from time to time. Any new Director who joins the Board is presented with a brief background of the Company and is informed of the important policies of the Company including the Code of Conduct for the Directors and Senior Management and the Code of Conduct for Prevention of Insider Trading.

Bharti Airtel

The Company has a formal induction process for newly appointed board members so as to familiarise them with the corporate philosophy and governance principles of the Company. Induction program is organised for two days in which the meetings are set up with the group

directors, corporate directors and business heads for better understanding of the business, its operations and its segments. Newly appointed board members are given orientation on the services, group structure, policies and processes adopted by the Company for attainment of its objectives.

Dr. Reddy's Laboratories

The Company believes that the Board be continuously empowered with the knowledge of the latest developments in the Company's businesses and the external environment affecting the industry as a whole. To this end, the Directors were given presentations on the global business environment, as well as all business areas of the Company including business strategy, risks and opportunities. The Directors also visited various manufacturing and research locations of the Company.

Hero Motors Ltd

Upon appointment, Directors receive a comprehensive Directors' Manual which includes Company's historical background, business profiles, organisation structure, codes and policies of the Company, internal controls and risk management systems and their roles, responsibility as Directors of the Company. Strategy meetings are held where business and functional heads share with the Board their short term and long term plans, major activities, likely risks and challenges with actions to mitigate them in their respective areas. The Board's suggestions and comments are incorporated in the business plans.

Tata Chemicals

The Directors interact with the management in a very free and open manner on information that may be required by them. Orientation and factory visits are arranged for new Directors. The Independent Directors are encouraged to attend training programmes that may be of relevance and interest to the Directors in discharging their responsibilities to the Company's stakeholders.

Director Evaluation

Evaluation of directors by peer group is making much headway in the US, UK and other developed countries of the world. Many corporate governance codes and stock exchange listing rules recommend or require an annual assessment of the performance of individual directors. Hampel Committee (1998) suggested that boards should introduce formal procedures to assess both their own collective performance and that of individual directors. The Combined Code (2008) in the UK lay down that 'the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors' (para A.6) In Australia, the ASX Principles also require the companies to disclose the process for evaluating the performance of the board, its committees and individual directors.

The global practices are diverse on evaluation of directors. Typically, the board chairman or chairman of the nomination committee or a senior independent director or a past chairman conducts appraisal of individual director's performance and comments privately to the director involved. Some companies have a structured performance review process which involves interview/interaction to share the experience of the individual director as board member. Information on the contribution of the concerned director is also collected on parameters such as attendance records, queries raised during the board or committee meetings, inputs or suggestions given at the meetings, contribution to discussion and decision-making etc.

Director's evaluation is all the more necessary in India in view of the long tenure and poor attendance record of independent directors in many companies. There is plethora of critics against independent directors expressed in the public forums, and published in media reports, committee reports and surveys. The charges range from low attendance to passiveness, incapability to 'hatch' man of the promoters. The Narayan Murthy Committee (2003) in its report noted that directors' evaluation is in germane stage in India. The Committee recommended evaluation of non-executive directors by a peer group comprising of the entire board of directors.

Director's evaluation is virtually non-existence in India. The same sets of individuals irrespective of their zero contribution to the board processes find birth in the board again and again till found inconvenient by the management. Out of 80 companies surveyed only 6 companies have one or the other form of evaluation of directors as evident from the annual reports of the companies for the year 2009-10. It is difficult to find out the actual practices followed by the companies in this regard. Excerpts from the Annual Reports (2009-10) of a few companies are:

Tata Chemicals

The performance evaluation of non-executive members is done by the Board annually based on criteria of attendance and contributions at Board/Committee meetings as also for the role played other than at meetings.

Wipro Ltd.

Evaluation of all Board members is done on an annual basis. This evaluation is lead by the Chairman of the Board Governance and Nomination Committee with specific focus on the performance and effective functioning of the Board, Committees of the Board and report the recommendation to the Board. The evaluation process also considers the time spent by each of the Board members, core competencies, personal characteristics, accomplishment of specific responsibilities and expertise.

Non-executive Director's Compensation

Compensation for non-executive and independent directors is a contentious issue of corporate governance. Whereas high compensation to non-executive directors may induce entrenchment and may affect independence of the director, insufficient compensation may not be justifiable keeping in view the time and efforts expected from them. Moreover, low compensation may not attract competent and professionally qualified persons to the board. This seems to the scenario in India. Small sized companies find it hard to get competent independent directors in view of low paying capacity of these companies. In large sized companies, the management/ promoter select 'independent' directors and offers hoards of rewards to them in the form of fee, commission and stock options. The expectation from the recipients of such high compensation in many cases is 'decent' behavior, no inconvenient questions and no challenge to wishes of the appointing authority i.e. the management. In the Satyam fraud the high profile independent directors of the company were blamed for not questioning the diversion of funds of the company to the non related family concerns by the disgraced chairman of the company Mr. Ramlinga Raju. Such directors were getting an annual remuneration of Rs. 1 million each. How it could be expected that such directors raised their voice against the antics of the chairman. Mr. Ram Mohan, thus, writes[149] "In exchange for this munificence, the worthies on the board are expected to question, challenge and even oppose management. I don't know if such people exist on such planet- I haven't met in my life time."

In India, the practice has been payment of the sitting fees which used to be nominal (Rs. 5000 per meeting). The maximum amount of sitting fee for attending each meeting of the board or a committee of the board has been increased to Rs.20000 in 2003. In addition to the sitting fee, non-executive directors may also be given a share in the net profits of the company by way of commission subject to the upper limit prescribed by the Indian Companies Act (1 percent of the net profits of the company). Some companies make a part of such payments by way of stock options. Clause 49 of the listing agreement requires the board of directors of the company to decide the remuneration of the non-executive directors including the independent directors with disclosure in the annual report of the company.

A majority of companies in India follows the practice of paying sitting fee and commission to the non-executive directors. But, there is a wide divergence in the compensation paid across companies and within companies. In one company, for example, one independent director is paid commission of Rs. 22.5 lakhs and sitting fee of Rs. 1.10 lakh, whereas in the same company another independent director was paid Rs. 2.25 lakhs plus sitting fee of Rs.30000. Reliance Industries paid Rs. 21 lakhs as commission on annual basis to each of its non-executive director besides sitting fee of Rs.20000 for each meeting attended[150]. Similarly, Infosys paid commission to its independent directors in the range of Rs. 49-65 lakhs in 2009-10. Ambuja Cements paid

[149] T T Ram Mohan 'Board Membership as Career' The Economics Times, New Delhi 09-12-2010
[150]Annual Report of Reliance Industries 2009-10

Rs. 9 lakhs to each of its independent director and additional Rs. 7 lakhs in 2009-10 to the member directors of the Audit Committee and Compliance Committee.

An excerpt from the annual reports (for the year 2009-10) of a few companies is given as illustration:

Bharti Airtel

The independent non-executive directors are paid sitting fees within the limits that could be paid without the approval of the Central Government, for attending the board/committee meetings. Further, a commission, duly approved by the shareholders, not exceeding 1% of the net profit of the Company calculated as per the Companies Act, 1956 is also payable to the independent non-executive directors on annual basis. Compensation of independent non-executive directors is linked with the number of meetings attended by the respective director during the financial year.

Dabur India Limited

Fees and compensation, if any, paid to any Non-Executive Director, including Independent Director, is fixed by the Board of Directors and is previously approved by the shareholders at the General Body Meeting.

Hindustan Unilever Ltd

The Independent Directors are paid sitting fees of Rs.20000/- for attending every meeting of the Board or Committee thereof and commission on profits at the rate of Rs. 5 lakhs for each year, in terms of the approval of the shareholders at the Annual General Meeting of the Company held on 24th June, 2005, which is valid for a period of five years up to 31st December, 2010. It is proposed to seek approval of the shareholders for renewal of the above resolution for further period of 5 years and enhancing the overall limits of remuneration payable to the Non-Executive Directors.

The Non-Executive Directors, who continuously serve minimum three terms of three years each, are also entitled for a cash retirement commission of Rs. 10 lakhs at the time of retirement.

I T C Limited

Non-Executive Directors are entitled to remuneration by way of commission for each financial year, up to a maximum of Rs. 6,00,000/- individually, as approved by the Shareholders. Non-Executive Directors' commission is determined by the Board based, inter alia, on Company performance and regulatory provisions. Such commission is payable on a uniform basis to reinforce the principle of collective responsibility. Non-Executive Directors are also entitled to sitting fees for attending meetings of the Board and Committees thereof, the limits for which

have been approved by the Shareholders. The sitting fees, as determined by the Board, are presently Rs. 20,000/- for attending each meeting of the Board, Audit Committee, Compensation Committee, Nominations Committee and Sustainability Committee and Rs. 5,000/- for each meeting of the Investor Services Committee. Non-Executive Directors are also entitled to coverage under Personal Accident Insurance.

Audit Committee

All codes of good practice in corporate governance and stock exchange listing rules require listed companies to constitute audit committee comprising wholly or mainly of independent directors. The role and function of audit committee is well established in many countries. Many codes around the world recommend specifically the size of the audit committee, qualification of audit committee members, and frequency of meetings of the committee.

The provisions of the SEBI Code applicable to the listed public companies are stringent and detailed. The revised Code prescribes setting up of ‘a qualified and independent audit committee’ with minimum of three directors out of which at least two-third is required to be independent directors. The Code requires all members of the committee to be financially literate and at least one member to have accounting or related financial management expertise. The revised Code has increased the minimum number of audit committee’s meeting to 4 from 3 in the original Code. The power and role of the audit committee has also been considerably enhanced as compared with the earlier Code (for details refer to Chapter 9). In fact, the audit committee prescriptions in India are among the ‘best’ of the international practices.

The average size of audit committee in India, as observed from the study of top 100 companies, has become larger from 3.45 in 2001 to 3.88 in 2010. As shown by Table 9.7, the median size has also expanded from 3 in 2001 to 4 in 2010. While the minimum size of audit committee is 3 over the years (in line with the regulatory provisions), the maximum size of audit committee was 5 in 2001 and 6 in 2005 and 2010. The average proportion of independent directors in audit committees across the companies under study has fallen from 0.90 in 2001 to 0.86 in 2010. The interesting trend is that in 2001 77.5 percent of companies had audit committees comprising entirely of independent directors, percentage of such companies fall down to 63.75 percent in 2005, and only 35 percent of companies in 2010 had audit committees comprising wholly of independent directors. This could be on account of tightening of the definition of independent director with effect from 01-01-2006. Number of audit committee meetings in a year also shows an increasing trend-- the average number of meetings has increased to 5.5 in 2010 from 3.06 in 2001. Similar trend is observable in median meetings over the years. The increase in average number of meetings is owing to the change in the regulations which now require 4 audit committee meetings in a year instead of 3 under the original Code. Companies with a significantly higher number of meetings were Tata Motors- 13 meetings in 2005; Tata Steel- 14 meetings in 2010; Bombay Dyeing-10 meetings in 2010; and ITC- 9 meetings in 2010.

Table 9.7: Audit Committees in Companies

	2001	**2005**	**2010**
Average Size of Audit Committee	3.45	3.45	3.88
Median Size of Audit Committee	3	3	4
Minimum Size of Audit Committee	3	3	3
Maximum Size of Audit Committee	5	6	6
Average Proportion of Independent Directors	0.90	0.89	0.86
Percentage of Companies with 100 % Independent Directors	77.5	63.5	35
Average Number of Meetings of Audit Committee	3.06	4.87	5.5
Median Number of Meetings of Audit Committee	3	5	5
Minimum Number of Meetings of Audit Committee	0	3	4
Maximum Number of Meetings of Audit Committee	8	13	14

Source: Author's estimation based on corporate governance reports of top 100 companies

Apparently, compliance with the Code provisions on audit committee formation and holding of audit committee meetings is very high in India. But that does not establish the effectiveness of the audit committee in discharging the mandated functions. It is indeed difficult to comment on it in the absence of published information on this count. Nevertheless, certain questionable practices as discerned from the annual reports of the companies need consideration. A very few companies in India publish the charter of the audit committee and report of the committee. Still, from those reports it is not clear as to what role audit committee had actually played in recommending the appointment of the statutory auditor of the company or how the review of internal control mechanism or risk management review had been done by the committee, what suggestions were given by the committees, or what suggestions were accepted by the boards. A lot of focus of corporate governance reforms is on the qualification of audit committee members. The SEBI Code requires all members of the audit committee to be financially literate with at least one member to have the expertise in accounting or related field. Annual Reports of most of the companies do not divulge details of financial literacy of its members. A general statement that 'all members of the audit committee have accounting and financial management expertise' or 'committee members are professionals having requisite knowledge of finance and accounting' is given which sounds ambiguous. Under Sarbanes-Oxley in the US, audit committees have to disclose whether the audit committee member meet the five-part definition of a 'financial expert'. This has not come about as yet in India.

Another issue is to do with the practice of the companies in India regarding composition of the audit committee. There are quite a few companies which have CEO of the company or the Managing Director of the company or Executive Chairman of the company as the regular

member of the committee. Further, in many companies, non-executive director members of the committees are the family-members of the promoters or close associates of the controlling groups. This does not diminish the dominance of the executive in the audit process and defeat the purpose for which the audit committee was conceived. The 'independence' of the independent directors on the committee is also a suspect in view of overriding role of the company promoters or the controlling groups in selecting, appointing and re-appointing independent directors.

The effectiveness of audit committee may also be judged by the duration of the meetings of the committee and the attendance records of the members of the committee. There are reports of meetings of the committee lasting for few minutes. A few companies have reported participation of audit committee members in the committee over telephone. How long deliberations can be done over telephone? How a review of internal control and risk management be done? Some other instances on the basis of the published information are: in one company chairman of the Audit Committee attended just 1 out of the 4 meetings in the year; in another company, out of 3 members of the audit committee one member attended 3 audit committee meetings over telephone and another member attended 2 meetings over telephone; in number of companies 1 or 2 members did not attend a single meeting of the audit committee. It seems the audit committees are not taken seriously in India. In many cases, 4 meetings are held in a year which is attended turn wise by the director members- in the first meetings 3 members would be present, in the next meetings 2 members present in the first meeting would be absent, and in the third meeting 2 members present in the second meeting would be absent. This suggests lack of interest and continuity in the functioning of audit committee.

Roles of the Chairman and Chief Executive Officer

The Indian codes of corporate governance (viz. the CII code, Clause 49 of the Listing Agreement, Revised Clause 49) while silent on the issue of separation of chairman and CEO, link independent (non-executive) chairman with the component of independent directors in the board of directors of the company. The committee appointed by the Confederation of Indian Industry (CII) recommended that if the chairman and CEO (or Managing Director) is the same person, independent directors should constitute 50 percent of the board, and 30 percent of the board in case of separation of the two positions.

The view of the Kumar Mangalam Birla Committee appointed by the Securities and Exchange Board of India (SEBI) on the subject was quite ambiguous. It was of the opinion that the chairman's role should in principle be different from that of the chief executive, though the same individual may perform both the roles.In the mandatory category of recommendations, the Committee dittos the CII recommendations of linking non-executive chairman with the composition of board of directors of the company. The recommendation of the Committee was incorporated in the SEBI code (Clause 49 as well reiterated in the Revised Clause 49 of the

Listing Agreement). In the non-mandatory category, the Committee recommended that a non-executive chairman (in case it is there) should be entitled to maintain a Chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties.

The Indian approach to the issue of duality is surprisingly different from many codes and guidelines elsewhere. The Code of Best Practices of the Cadbury Committee which influenced the formulation of codes and guidelines worldwide including the Indian codes recommends separation of the two positions. Sir Adrian Cadbury thus wrote 'the jobs of chairman and chief executive demand different abilities and perhaps temperaments. It is very much in shareholder's interests to ensure they are performed by different people'[151]. The Combined Code(2008) applicable to the companies listed in the UK contains the main principle (A.2) which states that the roles of chairman and chief executive should be split and further a chief executive should not go on to become chairman of the same company. Similarly, the Australian code requires the chairman of the company to be an independent non-executive director, and if the chairman is not an independent director, there should be a 'lead independent director'. Amazingly, the US corporate governance reforms including the much acclaimed Sarbanes-Oxley Act do not mandate the separation of the roles of chairman and CEO. Similarly the Revised Commercial Code of 2003 which is applicable to about 10000 large companies in Japan has no provision in the code that prohibits CEO duality. In France also, the Vie`not Committee while advocating the independent directors on the board made no prohibition of combining the two roles. In fact in France there is a strong concentration of power in the hands of the Pre`sident-directeur-ge`ne`ral (PDG, or CEO and chairman).

The approach of the SEBI code to the issue of duality of CEO although different from many codes and guidelines elsewhere is not unique. The Malaysian code of corporate governance, for example, prefers separation of the two roles to ensure that power is not centered in one individual. The code emphasizes that where the roles of chairman and CEO are combined, there should be a strong independent element on the board. Further, the decision to combine the roles needs to be publicly explained by the companies.

With the Indian code of corporate governance ambivalent on the issue of the duality, nearly 50 percent of the top 500 companies listed on the Bombay Stock Exchange have a separate chairman of the company[152]. Of the multi-national corporations (MNCs) operating in India, more than 80 percent have an independent chairman. This position is reversed in public-sector undertakings (PSUs), where more than 70 percent of the companies have a chairman cum managing director (CMD) with nearly 100 percent in public sector banking companies. To prevent concentration of power with one person, recently there was a move to separate the two positions. The Standing Conference of Public Enterprises (SCOPE) --the apex body of central

---

[151] Cadbury, 2002

[152] Based on author's calculation (Source: Directory of BSE,500, Mumbai

public sector undertakings in the country has strongly opposed the proposal. The argument is that the separation of chairman and CEO's post carries the risk of creating two power centers within the same organization and that may adversely affect productivity[153].

In the private sector, nearly one third of the publicly listed companies in India are promoted, controlled and managed by the 'industrial houses'. In these companies, the tradition of family dominance is entrenched in the governance system since the 'managing agency' times. Most of these companies are like extended Indian families ruled by a patriarch who is the family head and promoter of group companies. The personality of the promoter overshadows all corporate affairs. The CEO in such companies even if a professional and not the member of the controlling group family, has to follow the 'diktats' of the family[154]. Several instances of family domination over corporate governance and intolerance of the business families towards professional management are visible- sacking of Sunil Alagh, Britannia Industries dynamic CEO by NusliWadia in 2003; tussle between Rusy Modi, the icon of management with the Group Chairman of Tata Sons. The recent imbroglio in SKS Microfinance Ltd. demonstrates a power struggle involved in the founder chairman- CEO relationship. The sacking of Mr. Suresh Gurumani who as CEO of the company steered the company through a spectacularly successful IPO in July 2010, the first by a microfinance institution in India and the second the world over, has renewed the conundrum on the issue of decoupling the two positions. The active chairman may be perceived to usurp the role of the CEO. The clash of personality between the two would be inevitable in such circumstances and this is what happened in SKS. In case of disagreement between the CEO and the chairman, it may become problematic for the board of directors also, as the board may not know to whom to listen to.

In many family controlled companies, chairman and CEO are members of the same family. It is difficult in such circumstances for the chairman to be regarded as being independent or for the CEO to be able to exercise authority without being undermined by the family-head. There are many instances in family group companies where the CEO of the company has risen to take over as the chairperson of the same company. In many such companies the non-executive chairman is just a figurehead. The position of the chairman has been given to the founder of the group or the family head who is no more active and is regarded as the last step before the retirement from the active life. Thus, the linking of independent component of directors in the board of directors with the chairman (non-executive or executive) of the company in the SEBI code of corporate governance is inconsequential. Since the Indian corporate sector is dominated by companies controlled and managed by family groups, the structure should have been designed to deal with this specific Indian situation.

[153] U.D. Choubey, Director-General, SCOPE in an interview to the Hindustan Times published on 22.07.2010
[154] Dutta, 1997

Disclosure Practices

The issue of disclosure is generally regulated by the corporate laws of the countries. Codes of best practice and guidelines of some countries supplement the legal requirements concerning the disclosure of 'relevant' information and policies of company. In most of the countries, Codes and Guidelines put obligation of financial reporting on the board of directors. Partly as a result of the regulatory provisions and partly out of the realization by the Indian companies that 'transparent disclosures and empowerment of stakeholders are as necessary as solid financial results for creating and sustaining shareholder's value'[155] the nature and quality of disclosure in recent years has improved considerably. The improvement in disclosure practices has also come about on account of desire of companies to attract foreign institutional investors and/or access to international market through Euro issues, Foreign Currency Convertible Bonds (FCCB), Global Depository Receipt (GDR), and American Depository Receipt (ADR). Quite a few top Indian companies led by Infosys Technologies Limited have raised the quality of their corporate reports by increasing the quantum of voluntary disclosures.

An analysis of disclosure practices of the top 100 companies of the BSE indicates that while companies disclose the information as required under the law including under Clause 49 of the listing agreement, there is a considerable variance in the extent and quality of disclosures made by companies in their annual reports. Disclosure by some companies is embattled by ambiguous statements or general statements which do not convey any meaning. Some instances are:

"all the investors complaint received during the year are resolved";

"the Company has comprehensive guidelines in accordance with the SEBI Regulations, which advise and caution the Directors, management and executives on the procedures to be followed while dealing with securities of the Company. CG's Insider Trading Code helps in ensuring compliance with these requirements";

"a committee has been constituted to examine adoption of non-mandatory requirements";

"company has adopted the other non-mandatory requirements also (without giving the details)"

"all committee (audit) members have requisite knowledge of finance and accounts"

Many companies in India do not disclose the profile of all of the directors-- profile of only those directors who seek re-employment in the ensuing AGM of the company is given in the Annual Reports. Further, some companies only give a brief profile of such directors which is inadequate as compared with companies like Infosys, Tata Steel, and Reliance Industries. Only a few companies- Infosys and Bharti Airtel have given the report of the committees of the board i.e. Audit Committee, Nomination Committee in their annual reports. This is the best of the international practices. Other companies should emulate it. There are many cases in which

[155] Annual Report 2009-10 ITC Ltd.

disclosure on the composition of the board and attendance records of the directors in boards' meetings lack clarity. None of the companies have disclosed the duration of the boards' and board committees' meetings. The Naresh Chandra Committee strongly felt that the shareholders have a right to know how much time the board and its committees have spent in discussing the shareholders interest and recommended disclosure of the timing and duration of each such meeting, in addition to the date and member in attendance. The attendance record of the directors in board meetings and committees' meetings is never disclosed meeting wise. A case can be cited here, for illustration, which is applicable to all the companies in India:

Wipro Ltd. in its annual report 2009-10 makes the disclosure of attendance of the member directors in the audit committee meetings as follows:

Audit Committee met 7 times during the year-20.04.09, 15.05.2009, 20.07.2009, 16.10.2009, 17-18.01.2010, 01.02.2010, and 22.02.2010 (15.05.2009 and 01.02.2010 meetings were over telephone)

Name	Position	No of Meetings Attended
N. Vaghul**	Chairman	5
P. M. Sinha*	Member	4
B. C. Prabhakar**	Member	5

*Attended 3 meetings over Phone

**Attended 2 meetings over Phone

Disclosure Issue: This disclosure practice which is typical in India does not provide information as to which member(s) were present on which meeting. It may be possible that continuity of deliberations at the audit committee meetings is not maintained. It is also possible that in a particular meeting(s) only one member was present. Had the duration of the meeting been disclosed, the stakeholders would get to know the effectiveness of such meetings.

While the Management Discussion and Analysis Report (MDAR) section as part of the Director's Report contain among others risk concerns, many companies do not disclose risk management or disclose it briefly. Similarly, MDAR section includes segment wise or product wise performance, but the quality of disclosure varies. Disclosure is particularly lacking on the part of most of the companies on the description and risks of contingent liability. The Naresh Chandra Committee made a mandatory recommendation in this regard:

"It is important for investors and shareholders to get a clear idea of a company's contingent liabilities because these may be significant risk factors that could adversely affect the corporation's future health. Management should provide a clear description in plain English of each contingent liability and its risks, which should be accompanied by the auditors' clearly worded comments on the management's view. This section should be highlighted in the

significant accounting policies and noted on accounts, as well as in the auditor's report, where necessary" (Recommendation 2.5).

Shareholders' Grievances

The foremost area of corporate governance in which there is a considerable improvement in India is redressal of investors' grievances. The regulatory pressure on companies has brought out the positive results in this direction. An aggrieved investor can file complaint against the company at the office of Registrar of Companies, SEBI, and the company. Clause 49 mandates constitution of Shareholders/Investors Grievance Committee under the chairmanship of a non-executive director to look into the redressing of shareholders and investors complaints. Further, the auditor of the company is required to state in its certificate on corporate governance whether any investor grievance is pending against the company for a period exceeding one month.

Almost all the listed companies have constituted the investors grievance committees, and as per the annual reports of the companies such committees are quite active also in taking up the complaints of the investors. Most of the complaints from the shareholders are on routine matters pertaining to non-receipt of dividend warrant, non-receipt of annual reports etc. which are immediately attended by the companies.

9.6 Challenges to Promote Good Corporate Governance

Family Domination: Corporate sector in India is dominated by the companies belonging to the 'industrial houses'. The tradition of family dominance is entrenched in the Indian corporate governance since the 'managing agency' times. Most of the Indian companies are like extended Indian families, a maze of complex holdings all interlinked together giving the shape of a pyramid ruled by a patriarch who is the family head and promoter of group companies. The personality of the promoter overshadows all corporate affairs. The boards of directors of such companies which used to consist of the family members and associates have undergone a change to meet the requirements of the SEBI Code of Corporate Governance. In many companies, however, the culture of family dominance is still ingrained. Unlike the companies in the US and the UK, most Indian companies have a controlling family-group which nominates all board members. The family members, in most companies have been nominated to important board committees also viz. audit committee and remuneration committee. In reality, the families have adjusted the control mechanism to adhere to the changing statutory and regulatory requirements without letting go the levers of power. It is not unusual for the families to intervene in the managerial processes in an inappropriate manner, ignoring the sovereignty of the boards and principles of corporate governance.

Role of Independent Directors: Role of independent directors in the boards of companies is an issue which is much talked about in India especially after the debacle of the Satyam. Independent directors were imposed by the regulators on the Indian boards which accustomed to work as a

‘cozy club’ or ‘rubber stamp’, at times showering bouquets of praises on the moves including antics of the promoters of the companies who usually happened to be the established ‘industrial families’. It seems not much has changed in most of the companies in India with the advent of ‘independent directors’ on the boards. The promoters have learned to live with them slightly adjusting the ways boards were functioning before.

The debacle of Satyam in 2009 demonstrated the ineffectiveness of independent directors. The independent directors at Satyam cleared the deal to divert the funds of the company for the unrelated family concerns of the disgraced chairman of the company. The high profile independent directors chose to remain silent spectators to the pranks of the chairman of the company reducing themselves to the ‘passive observers’.

The main reasons for failure of independent directors in India are that most of the public listed companies’ shareholding is structured differently. The family or founders bring in their relatives and friends as board of directors and control the organization. The independent directors do not receive insider information of the organization, as senior management is loyal to the founder / family. Hence, all effort is made to protect the family/ founders authority and control, rather than interest of the public shareholders. Therefore, though the qualifications of the directors are good and relevant they have little impact. The directors are appointed more to add prestige to the board and company, a men’s club is formed and nobody bothers to ask the right questions. For the directors it is a status symbol to be on the board, along with the director’s fee, free travel and various indirect privileges. In such a scenario, the board’s independence is lost and there is hardly any focus on curtailing fraudulent activities.

Shareholders’ Democracy: Retail shareholders or individual shareholders, although contribute to the equity capital of companies, they have a little influence and power in the functioning of companies. The legal framework and policy initiatives of the regulators are geared towards the protection of the interest of investors including minority shareholders. In practice, however they have no real effective rights and at times have to bear the brunt of unscrupulous promoters. The views of individual shareholders are seldom taken seriously and their votes have virtually no effect. The promoters and company managements ‘rush’ through the agenda at the AGMs while maintaining ‘cordial’ atmosphere at the meeting. Managements which have the control over the information reveal only what they want to, leaving the retail shareholders generally disenfranchised.

In India, currently, there are about two dozen SEBI recognised investor associations in India, out of which almost half-a-dozen are inactive. These associations are finding it difficult to operate in the current environment being wholly dependent on the grants of the government and find solace in organizing investors meet or conferences occasionally. The retail investors in India being scattered, ill-informed, and un-organized usually suffer out of the mis-management of

companies. They have no means to sense the governance problems in companies. By the time antics of promoters are leaked, it becomes too late to quit the company. The result is obvious.

Multiple Regulatory Agencies: The regulatory framework of corporate governance in India is three tiered comprising of the Ministry of Corporate Affairs (MCA), Securities and Exchange Board of India (SEBI), and Stock Exchanges. The legal framework is laid down primarily by the Companies Act, 2013; Securities (Contracts) Regulation Act, 1956; SEBI Act, 1982; and the Listing Agreements.

The regulatory framework in India places the oversight of listed companies partly with the Ministry of Company Affairs (MCA), partly with the Securities and Exchange Board of India (SEBI) and partly with the stock exchanges. In addition, in case of banking companies, Reserve Bank of India (RBI), and Insurance Regulatory and Development Authority (IRDA) exercise power of supervision over insurance companies. This fragmented structure consisting of multiplicity of agencies gives rise to regulatory arbitrage and weakens enforcement. It raises more often such questions as: is it the MCA or the SEBI which is mandated with the responsibility of protecting the investors; out of these two which is the nodal agency; in case of conflicting regulations of the MCA and SEBI, which regulation would prevail.

An in-depth revision of the three-tiered regulatory system would reveal whether changes in the respective roles and responsibilities of the involved institutions and their supervisory functions are in order. Clarification of responsibilities could strengthen enforcement. SEBI and the exchanges need to cooperate more closely to effectively monitor and enforce compliance with the listing agreement. It is imperative that steps are taken to clarify the division of responsibilities among stock exchanges, SEBI and MCA to avoid unintentional regulatory overlap and potential conflicts.

Surveillance and Enforcement mechanism and the Court system[156]: Although laws in India are generally comparable to those in the UK, the court system is seen as inadequate to handle the volume of cases being brought to trial. This results in delays in the delivery of justice. Verdicts are handed over 10 to 20 years after the incidences have occurred. Furthermore, corruption in the lower courts delays the delivery of verdicts and increases the cost of litigation. The establishment of Company Law Tribunal is expected to bring some reforms to this area.

[156]Adopted from *www.iimahd.ernet.in_~jrvarma_papers_iimbr9-4*

Case of Satyam Computer (2009)[157]

Satyam Computer Services Ltd (Satyam) was founded in 1987 by Ramalinga Raju (Raju) and his brother Rama Raju as a private company with just 20 employees to develop software and provide consultancy services to large corporations. The company became a skyrocket success riding on the Y2K phenomenon as the end of the millennium approached. It debuted on the Bombay Stock Exchange in 1991 followed by a New York Stock Exchange listing in 2001. The company earned the distinction of 'India's one of the most remarkable and entrepreneurial companies' from the World Economic Forum. Even though public, Satyam remained a company dominated by its co-founder cum Chairman Mr. Ramalinga Raju who was conferred with the IT Man of the Year 2000 award by Dataquest.

In 2003 Satyam signed a long-term contract with the World Bank to provide IT services. In 2006, Satyam had about 23,000 employees and was reporting $1 billion in revenue. By the end of 2008, the company became fourth largest IT Company of India. It claimed to surpass $2 billion in revenue, and had about 53000 employees. In 2008, the company received "Golden Peacock Award' for excellence in corporate governance from the London based World Council for Corporate Governance. The company had in place an optimum combination of non-executive directors and executive directors, an independent audit committee, a nomination committee and remuneration committee consisting of independent directors. The company had been calling investors meet also regularly. The independent directors in company were highly acclaimed professionals ranging from the founder of the Pentium Mr. Vinod Dham, Prof. Krishna Palepu of Harvard Business School, Dean of Indian School of Business Mr. M Rammohan Rao, Mr. T.R. Prashad, former Cabinet Secretary, and other academicians.

Confession of the Fraud

In one of the biggest frauds in India's corporate history, B. Ramalinga Raju, founder and CEO of Satyam Computers, announced all of a sudden on January 7, 2009 that his company had been falsifying its accounts and doctoring the books of accounts of the company for years. The self confession "with deep regret and burden on conscience" plunged all stakeholders into deep trouble with completely dark future. As per the confessions, company's financial statements had overstated cash reserve of Rs. 5040 crores which did not exist, accrued interest of Rs. 376 crores, debtors Rs. 2160 crores, and understated liabilities of Rs. 1230 crores. Ironically, Satyam means "truth" in Sanskrit, but Raju's admission -- accompanied by his resignation -- shows the company had been *asatyam* (or untruth), at least regarding disclosure of its financial performance to the investors, shareholders, clients and employees. The scale of India's biggest corporate fraud was estimated at around Rs. 7000 crores.

[157] Adopted from Anil Kumar (2012)

Raju was compelled to admit to the fraud following an aborted attempt to have Satyam invest $1.6 billion in Maytas Properties and Maytas Infrastructure -- two firms promoted and controlled by his family members. The Board of Directors of the company on December 16, 2008, cleared the deal of acquiring 100 percent stake in Maytas Properties and 51 percent stake in Maytas Infrastructure.Following the deal, institutional investors of the company who had 61.57 percent shareholding in the company (as on Sep. 30, 2008) questioned the propriety of using the software company's cash pile to buy two infrastructure firms belonging to the promoters. The investors pummeled its stock on the New York Stock Exchange and Nasdaq. The board hurriedly reconvened the same day and the deal was aborted. The matter however didn't end there, as Raju might have hoped. In the next 48 hours, resignations streamed in from Satyam's independent directors.

Resigning as Satyam's chairman and CEO, Raju said in the confession addressed to his board, the stock exchanges and the market regulator Securities and Exchange Board of India (SEBI) that Satyam's profits were inflated over several years to "unmanageable proportions" and that it was forced to carry more assets and resources than its real operations justified. He took sole responsibility for those acts. "It was like riding a tiger, not knowing how to get off without being eaten," he said. "The aborted Maytas acquisition was the last attempt to fill the fictitious assets with real ones." Raju acknowledged that Satyam's balance sheet included Rs. 7,136 crore (nearly $1.5 billion) in non-existent cash and bank balances, accrued interest and misstatements. The company, as per the confession had also inflated its 2008 second quarter revenues by Rs. 588 crore ($122 million) to Rs. 2,700 crore ($563 million), and actual operating margins were less than a tenth of the stated Rs. 649 crore ($135 million).

Aftermath

The January 7 confession of Raju emanated shock waves across the corporate sector in India, dumbfounded the regulators, and pummeled the shares of the company. The share of the company nosedived from a high of Rs.178.95 on January 6, 2009 to below Rs 40, wiping out Rs 9376 crore of investors' wealth in just one day. The Indian stock market regulator, the Securities and Exchange Board of India (SEBI) commenced investigations immediately under various SEBI regulations. The Ministry of Corporate Affairs of the Central Government separately initiated a fraud investigation through its Serious Fraud Investigation Office (SFIO). Following the January 7 letter and in accordance with the requirements under the Indian and the United States accounting standards, PricewaterhouseCoopers (PwC), Satyam's auditors, issued a letter stating that the audit reports and the opinion prepared by them for Satyam should not be relied upon. Mr. Raju, his brother (who was the Managing Director on the Board of Satyam) and the former Chief Financial Officer (CFO) were arrested. Two PwC partners were also arrested in connection with the fraud. Their bail applications were refused by the Metropolitan Magistrate's court in Hyderabad and they continue to remain in police custody. Since then, Raju and his other accomplishes have been in and out of custody, even as they continue to fight a protracted legal

battle. The Institute of Chartered Accountants of India (ICAI), the body that regulates accounting firms in India, has also commenced an investigation of the auditors. The regulatory authorities in India also initiated proceedings against Maytas Infra and Maytas Properties, including seeking the removal of their respective boards and replacing them with Government nominees.

Several class action suits were filed in the District Court of the Southern District of New York, against Satyam, Mr. Raju, his brother and the CFO for violations of US federal securities laws. The members of the class have been identified as the purchasers of American Depositary Shares between 6 January 2004 and 6 January 2009.

Importantly, the Ministry of Corporate Affairs filed a petition before the Company Law Board (CLB) to prevent the existing directors from acting on the Board and to appoint new directors. On 9 January 2009, the CLB suspended the current directors of Satyam and allowed the Government to appoint up to 10 new nominee directors. The swiftness with which the Ministry of Corporate Affairs acted in superseding the board of Satyam and appointing the government nominees on the board prevented a sure liquidation of the company after the fraud of such a large magnitude had surfaced. Subsequently, the new, six-member Board appointed a Chief Executive Officer and external advisors, including the accounting firms KPMG and Deloitte to restate the accounts of Satyam.

The new Board of Satyam met numerous times since it was constituted in January 2009. The priority of the new board was to sell a portion of the company to a strategic investor through a bidding process. It was not an easy task as the key issues facing a potential bidder was the lack of clarity on the financial statements of Satyam, the ability to continue with existing client contracts (which are critical for a services company) and the outcome of various legal proceedings against the company, including the class action law suits in the United States. Finally in April 2009, Mahindra group beat Larsen & Toubro in the bidding process to acquire the company. Satyam has been rebranded as Mahindra Satyam and is attempting to regain its past glory.

Intent and modus-operandi of the Scam

Satyam disaster the largest corporate scam in India has the modus operandi similar to other major scams in other parts of the world - top man cooks books, connives with the auditors, shows great results, and embezzles the funds. The difference in Satyam's case is that instead of running, the scamster confessed. At WorldCom, the CFO and the CEO were knowingly misstating the accounting and financials of the firm; at Tyco, the CEO and the CFO were knowingly taking money from the company for personal purposes. Even though Satyam is dubbed as 'India's Enron', there is difference between Enron and Satyam. At Enron, the CEO obscured, while whistle-blowers came out with the truth; at Satyam, there were no whistle-blowers, the CEO blew the whistle on himself. Raju confessed to the scam instead of the truth being dragged out in prolonged inquiries.

The Satyam fraud, as per the SFIO report, started in 2001 with the falsification of accounts. The aim of the scam was to prop up the shares of the company and boost market value by showing exceptionally good financial results and then the promoters quietly sold the shares at inflated prices. The proceeds were then used to buy land to take advantage of booming real estate at that time. In fact, founder B. Ramalinga Raju had set up as many as 374 infrastructure firms and eight investment companies to help him become a land baron, the report has found. In March 2001, the stake of the promoters (Raju and his family) was 25.6 percent which as a result of off-loading came down to 8.74 percent in March 2008. As per the SFIO findings, the promoters sold nearly 3.9 crore shares and raised cash amounting to Rs 3029 crores.

The scam also involved diversion of funds of the company to buy several thousands of acres of land to ride a booming reality market. Two family controlled firms of the disgraced chairman-Maytas Properties and Maytas Infrastructure, controlled land and lucrative contracts.

The scale of the fraud started accelerated sometime in mid-2007 when the company showed huge cash balances and fixed deposits in several banks of international repute. It was, however, actually starved of funds and the promoters were desperate to raise money to keep the company afloat.

The scam was crafted and operated by the disgraced chairman by incorporating 40 front companies, maintaining fictitious bank accounts on behalf of such companies, raising bogus invoices, forging board's resolution to borrow, and employing 'ghost' employees. As per the CBI investigations, a regular flow of applications like Operational Real Time Management (OPTIMA), Satyam Project Repository (SRP), Project Bill Management System (PBMS), Invoice Management System (IMS) and Excel porting were used to create inflated data in the account of Satyam Computers. The OPTIMA were used for creating and maintaining the projects, SRP for generating the project ID, PBMS for generating bills, and IMS for generating invoices were used for purporting the fraud; while Excel Porting were used for directly accessing company's account and hiding the invoices. 7561 invoices were found to be hidden in the IMS. These 7561 invoices were worth Rs 5,117 crores. Investigators discovered that the accused had already entered 6603 out of these false and fabricated invoices amounting to Rs 4,746 crores into their books of accounts thereby inflating the revenues of the company to this tune.CBI found that the guilty were also extremely smart, they tabulated balance sheets using computers that could not be tracked. Office data showed that a few officers would make entries late in the night, toward the last quarter of the month. The manipulated balance sheets were thus created.

Flaws in Corporate Governance

The corporate governance model of Satyam had certain flaws. The promoters of the company held a small percentage of equity. Their concern was that poor performance would result in takeover or divesting of their control over the company. The promoters especially Mr. Raju built

up his clout in the company and outside by showing fabulous results and floating success stories. The numerous awards conferred on Mr Raju placed him as the charismatic leader of the company. He had unquestioned control over the company.

The board of directors of Satyam had well acclaimed persons as the members. The board failed miserably in its prime duty of oversight. The fraud had been cooking in Satyam for years together. The board of directors of the company composed of a majority of independent directors, and the 'independent' Audit Committee of the Company remained either ignorant of the whole scam or turned a blind eye to wrong practices The promoters were reducing their stake in the company by off-loading the shares. At the behest of the promoters the board cleared the deal of acquiring family concerns of the promoters even though it was a major departure from the normal activities and expertise of Satyam. It was clearly a failure on the part of the board of directors of the company especially independent directors who cleared the deal ignoring the interest of the other (majority) shareholders. The high profile independent directors chose to remain silent spectators to the pranks of the chairman of the company reducing themselves to the 'passive observers'. The ongoing investigations into the Satyam scam showed that not a single member on the board of directors opposed the fraud that the company was engaging in. The scam robbed investors of around 14,000 crores went unopposed even as the Managing Directors and Chairman of the Company walked away with 2,700 crores. The Central Bureau of Investigation (CBI) said in a report that the members of the Board of Directors had acted as "rubber stamps", unwilling to oppose the fraud. Not a single note of dissent has been recorded in the minutes of the Board meetings. Evidently, the independent directors had conflicted interest of losing continuance of their job in the company from which they were getting remuneration of Rs. 12 lakhs each per year for attending 6 board meetings. One of the independent directors drew over Rs.90 lakhs for providing 'coaching to the company's top management.

The audit committee of Satyam failed in its duty to act on a whistle blower's expose. As per the investigations of SFIO, on 18 December 2008, two days after the Satyam board met and decided to acquire two group firms—Maytas Infra Ltd and Maytas Properties Ltd—independent director Krishna Palepu received an anonymous email by an alias, Joseph Abraham. That email exposed the fraud. Palepu forwarded the email to another independent director, M. RammohanRao, Chairman of the Audit Committee forwarded that email to S. Gopalakrishnan, partner at Price Waterhouse, the company's auditors. Gopalakrishnan told Rao over phone that there was no truth to the allegations and assured him of a detailed reply in a proposed presentation before the Audit Committee on 29 December. That meeting did not take place. A new date—10 January—was fixed.

Another questionable corporate governance practice in India is that of non-disclosure of pledging of shares by the promoters or controlling shareholders. Mr. Raju had pledged most of his promoters' stake to borrow funds. The lenders enforced the pledge following a decline in market

price of shares of the company resulting in a decline in the shareholding held by Mr Raju from 8.74 percent in March 2008 to merely 3.6 percent as on January 1, 2009. The stakeholders of the company had no clue about the depleting shareholding of the promoters in the absence of any disclosure. This has highlighted the need to enhance the disclosure requirements for promoters to disclose details of pledge of shares. The disclosure need to be event-based as well as period-based. The SEBI has now made it mandatory for the promoters and the promoter group of listed companies (essentially the principal or controlling shareholders) to disclose the creation and the enforcement of a pledge on the shares held by such persons.

Flaws in External Audit

Satyam management had been inflating revenues and underestimating liabilities for years together. Price Waterhouse (PW) India was the auditors of the company since 2000. Satyam scam is the clear case of audit failure as the auditors did not follow standard accounting and audit practices. As per the investigation of the SEC, the five audit firms of Price Waterhouse India- Lovelock & Lewes; Price Waterhouse, Bangalore; Price Waterhouse & Co, Bangalore; Price Waterhouse, Calcutta; and Price Waterhouse & Co, Calcutta- did not conduct the audit as per prescribed standards.

The Satyam fraud is a total failure of corporate governance. It provides evidence that despite sound norms of corporate governance unscrupulous persons have ways to circumvent the law. The Satyam fraud has also highlighted the multiplicity of regulators, courts and regulations involved in a serious offence by a listed company in India. Some of the regulators investigating Satyam include: the Ministry of Corporate Affairs (Government of India) including the Serious Fraud Investigation Office, the Registrar of Companies in Hyderabad, the Company Law Board; the Central Bureau of Investigation; Income Tax Department; the Enforcement Directorate; the Provident Fund authorities; the Securities and Exchange Board of India; and the Institute of Chartered Accountants of India. The impact of several parallel investigations on the successful prosecution of the accused is unclear. The wheels of justice grind slowly in India. It will be interesting to see the outcome of the investigations in India against professionals such as auditors and whether any proceedings are initiated against the former independent directors or other employees of Satyam.

References

Anil Kumar (2012) *Corporate Governance: Theory and Practice Ethics and Social Responsibility of Business.* International Book House Pvt Ltd.

Anil Kumar, Jyotsna Rajan Arora *(2014) Governance, Ethics and Social Responsibility of Business* International Book House Pvt Ltd.

Baig, W. (1971).*Pattern of Company Management in India,* Nariman Prakashan, Aligarh.

Balasubramanian, N. (2004). 'Economics Reforms, Corporate Boards and Governance' In D. Reed and S. Mukherjee (Eds): *Corporate Governance, Economics Reforms and Development,* Oxford University Press, Oxford.

Bansal, C.L. (1987). 'A Micro Analytical Study of the Board of Directors of Corporate Leaders in India', Unpublished Ph.D. Thesis, Department of Commerce, University of Delhi, Delhi.

Bardhan, P. (1984). *The Political Economy of Indian Development*, Basil Blackwell, Oxford.

Basu, S.K. (1975). 'The Managing Agency System in Prospect and Retrospect' quoted in N.K. Sengupta (1983), *Changing Patterns of Corporate Management,* Vikas Publishing House, New Delhi: 17.

Chakraborty, S.K. (1983). *Board of Directors in India: Their Statics and Dynamics,* All India Management Association.

CII (1998).*Desirable Corporate Governance: A Code*, Confederation of Indian Industry.

Dutta, S. (1997).*Family Business in India* Response Book, New Delhi.

Goswami, Omkar (2001). 'The Tide Rises, Gradually: Corporate Governance in India' OECD Development Centre, Paris

Gupta, L.C. (1989). *Corporate Boards and Nominee Directors* Oxford University Press, New Delhi

Gupta, L.C. (2005). *Indian Household Investors Survey*, Society for Capital Market Research and Development, New Delhi.

Hazari, R.K. (1966). *The Structure of the Corporate Private Sector: A Study of Concentration, Ownership and Control*, Asia Publishing House.

ICRA (2005).*Emerging Board Practices - A Survey*, Feb.

Joshi, Vasudha (2004). *Corporate Governance: The Indian Scenario,* Foundation Books, New Delhi.

Kapur, Vinit (1991). 'Top Decision-making Organization in Indian Industry (A Study of Corporate Practices)'.Unpublished Ph.D. Thesis .Deptt.of Commerce, Delhi School of Economics, University of Delhi.

Khanna, T. and K. Palepu, (1999),'Emerging Market Business Groups, Foreign Investors and Corporate Governance', *Working Paper No. 6955,* National Bureau of Economic Research.

Lokanathan, P.S. (1935).*Industrial Organisation in India,* London.

Mehta, D.R. (2004). 'Good Corporate Governance: Towards Greater Effectivness', In Ramesh K. Arora and TanjulSaxena (eds.) *Corporate Governance : Issues and Perspectives,* Mangaldeep Publications.

Mukherjee Reed, A. (2001). *Perspectives on the Indian Corporate Economy: Exploring the Paradox of Profits,* Palgrave, London.

Namajoshi, M.A. (1956). 'The Development of the Large Scale Private Sector in India', Unpublished thesis, Gokhale Institute of Politics and Economics, Poona.

Narayana Murthy Committee (2003).*Report on Corporate Governance,* SEBI.

Panchali, J.N. (1999). 'Ownership Strcuture and Financial Performance: An Inquiry into Corporate Governance in Indian Corporate Sector', UTI Institute of Capital Markets, Working Paper.

Praveen B Malla (2010) *Corporate Governance: History, Evolution and India Story.* Routledge.

Rungta, R.S. (1970). *Rise of Business Corporations in India: 1851-1900*, Cambridge University Press, Cambridge.

Sarkar, Jayati and Subrata Sarkar (2000). 'Large Shareholder Activism in Developing Countries: Evidence from India,' *International Review of Finance,* 1 (3): 161-94.

SEBI (1999).*Report of the Committee on Corporate Governance* (Kumar Mangalam Birla Committee).

*SEBI Manual,*Taxmann Publications, New Delhi, 2001, 2003, 2005.

Sen, Kunal and Rajendra Vaidya (1998). 'India' In Jose M. Fanelli and RohintonMedhora (eds) *Financial Reforms in Developing Countries* Macmillan Press Ltd., Hampshire, U.K.: 57-89.

Sengupta, Nitish K. (1983).*Changing Patterns of Corporate Management*, Vikas Publishing House Pvt. Ltd., New Delhi.

Som, Lalita (2006). *Stock Market Capitalization and Corporate Governance,* Oxford University Press, New Delhi.

Tricker, R.I. (1984).*Corporate Governance,* Gower Publishing Co. Ltd., Aldershot, England.

www.iimahd.ernet.in_~jrvarma_papers_iimbr9-4