

# CDDRL

## WORKING PAPERS

Number 97  
January 2009

### ***Law Enforcement and Stock Market Development: Evidence from India***

Vikramaditya Khanna  
University of Michigan Law School

Center on Democracy, Development, and The Rule of Law  
Freeman Spogli Institute for International Studies



Additional working papers appear on CDDRL's website: <http://cddrl.stanford.edu>.

Paper prepared for the Law and Economy in India Project at the Center on Democracy, Development, and The Rule of Law.

Center on Democracy, Development,  
and The Rule of Law  
Freeman Spogli Institute for International Studies  
Stanford University  
Encina Hall  
Stanford, CA 94305  
Phone: 650-724-7197  
Fax: 650-724-2996  
<http://cddrl.stanford.edu/>

### **About the Center on Democracy, Development and the Rule of Law (CDDRL)**

CDDRL was founded by a generous grant from the Bill and Flora Hewlett Foundation in October in 2002 as part of the Stanford Institute for International Studies at Stanford University. The Center supports analytic studies, policy relevant research, training and outreach activities to assist developing countries in the design and implementation of policies to foster growth, democracy, and the rule of law.

### **About the Author**

Vikramaditya Khanna is a Professor of Law at the University of Michigan Law School. His research and teaching interest includes corporate and securities laws, law in India, corporate governance in emerging markets, corporate crime, corporate and managerial liability, and law and economics. Prof. Khanna was the founding editor of the India Law Abstracts and the White Collar Crime Abstracts on the Social Science Research Network, and was a visiting professor at Harvard Law School, a senior research fellow at Columbia Law School and Yale Law School, and a visiting scholar at Stanford Law School. He holds a S.J.D. from Harvard Law School.

# LAW ENFORCEMENT & STOCK MARKET DEVELOPMENT: EVIDENCE FROM INDIA

By: Vikramaditya Khanna<sup>†</sup>

© Vikramaditya Khanna. All rights reserved.

## I. INTRODUCTION

Corporate governance reform is a global phenomenon sweeping through the US, Europe, China, Korea, India, Latin America and many other places.<sup>1</sup> These reforms have been accompanied by a surge in corporate governance scholarship focused on emerging markets.<sup>2</sup> This research suggests, although not uniformly, that “better” corporate law and governance tend to be correlated with better stock market development, more dispersed ownership structures, and higher firm profitability, amongst other things.<sup>3</sup> These findings have sparked debate and thought on why these correlations exist and whether there are particular features of corporate law and governance that matter more than others to these economic measures. Indeed, recent research in developed markets has begun to focus on enforcement of corporate and securities laws as a critical feature in determining the health and growth of stock *markets*.

However, there is little examination of how governance reform and enforcement may matter in an *emerging market*. Such an examination is important because emerging markets usually have weaker enforcement, but many of them appear to benefit from governance reform. Exploring how this occurs may shed some light on the connection between law, enforcement and stock market development. This paper pursues this by exploring why corporate and securities laws matter in a large emerging market – India. My analysis suggests that although India’s substantive corporate law reforms were received positively by the market, there was virtually no enforcement of these reforms for a number of

---

<sup>†</sup> Professor of Law, University of Michigan Law School. Email: [ykhanna@umich.edu](mailto:ykhanna@umich.edu) or [prof.vic.khanna@gmail.com](mailto:prof.vic.khanna@gmail.com). My thanks to \_\_\_\_ Thomas Heller, Erik Jensen and participants in the Stanford University Workshop on Law & Development in India for comments and suggestions. I also express my gratitude to \_\_\_\_ for excellent research assistance.

<sup>1</sup> See Arcot & Bruno (2007), Khanna (2008), Dharmapala & Khanna (2008), Clarke (2004), Howson (2008), Gorga (2008), Black & Kraakman (1996), Black, Jang & Kim (2005).

<sup>2</sup> See Khanna (2008), Dharmapala & Khanna (2008), Clarke (2004), Howson (2008), Gorga (2008), Black & Kraakman (1996), Black, Jang & Kim (2005)

<sup>3</sup> See La Porta, et al (1997), (1998); collecting cites.

years. This raises a puzzle: why did the Indian law reforms appear to be associated with substantial growth in the Indian markets when enforcement of those laws was very weak?

To answer this question we need to focus on the important drivers of Indian stock market growth at that time and how those might be influenced by law and enforcement. Indian stock market growth was fueled by increased Foreign Institutional Investor (FII) investment, which was followed and accompanied by increased investment by domestic and other investors. However, the critical question is why did the first players (FIIs) increase their presence and interest in the market? The high anticipated returns in the Indian stock market were important features, but research on India suggests that law reforms and their enforcement were important too (Dharmapala & Khanna, 2008). Thus, the question becomes why were FIIs motivated to increase their investment in India upon the promulgation of new laws even when they were not immediately enforced?

I examine a number of explanations and find plausibility in some of them (e.g., signaling, role of Industry), but regardless of which of these explanations one finds most convincing we need an account of why delayed enforcement was sufficient to make investment in India more attractive at the margin for FIIs at that time. I suggest that given the high returns available in India, FIIs may have thought that the need for enforcement was not pressing then (as the chance of insider diversion may not be high at that time), but could become so in the next few years when the market eventually cooled down. Thus, enacting the law now was attractive because then it would be available once the chance of diversion increased. Further, once FIIs started coming to India other investors also increased their investments in Indian firms.<sup>4</sup> As the number of investors swelled, this fueled the growth of the Indian markets, while simultaneously creating the constituency that would seek active enforcement when a downturn eventually comes and the chances of diversion increase.<sup>5</sup> Further, in the interim between enactment and enforcement the FIIs could perhaps take some self-protective measures (e.g., taking board seats on Indian firms).

---

<sup>4</sup> The pattern of growth appears much like an informational cascade (sometimes called herd behavior) where one set of investors' increased trading (e.g., FIIs) led to more trading by other investors which then led to yet more trading by others and so forth. See Bickchandani, Hirshleifer & Welch (2002).

<sup>5</sup> One might conjecture that most law reforms arise in response to scandals so enforcement is essential to secure confidence in the market, but in India the reforms came not from scandal but from Industry where the urgency of enforcement may not have been as necessary to induce investment.

This analysis suggests that enforcement is important to the growth of stock markets, but active civil enforcement of corporate laws may not always be critical to their *initial* development. Of course, continued weak enforcement is likely to undermine a stock market, but early on strong civil enforcement of corporate law may not always be essential. Indeed, this has been the experience of many countries when their stock markets were developing. If we examine the US and the UK some key features leading to the growth of their financial markets were growth in the economy, need for external capital, and rules, norms and understandings that protect or will attract larger investors to the market (Coffee, 2001a; Rajan & Zingales, 2003). Once larger investors enter a fast growing market, one tends to see share price increases that are likely to attract smaller investors to the market and the cascade develops.<sup>6</sup> In India, something similar has happened although the assurances to potential investors were provided more by Industry and government together.

This leads to a number of further questions which I can only begin to explore in this paper. For example, how much can we generalize from the Indian experience to other emerging markets? Might the unique role of Indian Industry support for governance reforms influence how important enforcement is? Might criminal enforcement be more critical to stock market development than civil enforcement of corporate law? Answers to these questions help to flesh out the importance of enforcement and how it interacts with the background context of the law reforms.

Part II begins by briefly discussing the previous literature on the connection between law (specifically corporate and securities laws) and stock market development. With this background in mind, Part III examines the development of modern corporate governance in India. Part IV uses the Indian experiences to explore the connections between enforcement and stock market development. Part V concludes.

## II. CONNECTIONS BETWEEN STOCK MARKET DEVELOPMENT AND CORPORATE & SECURITIES LAWS

The relationship between the law and stock market development has captured the imagination of the academy as well as governments, practitioners and other institutions (e.g., the World Bank). The modern genesis for this

---

<sup>6</sup> See Bickchandani, Hirshleifer & Welch (1992). Cascades can be notoriously fragile, which could be reduced or addressed by law changes to some extent.

discussion starts with the seminal articles of La Porta, Lopez-de-Silanes, Schleifer & Vishny (1997, 1998) (LLSV). These articles find that countries with a common law legal system tend to have more developed stock markets, more dispersely held firms, and higher firm market values than countries with a civil law legal system.<sup>7</sup> LLSV, and others, further suggest that the common law's greater protection of property rights (especially those of smaller shareholders)<sup>8</sup> and its lighter regulatory hand, which facilitates private ordering, are more conducive to the growth of stock markets than the civil law (the "legal origins" account).<sup>9</sup>

Although these papers have generated tremendous interest, many economists and legal academics argue that the "legal origins" account is not a convincing explanation for why common law countries have more developed stock markets (Rajan & Zingales 2001; Roe, 2006; Coffee, 2001a; Nenova, 2005).<sup>10</sup> Instead, changes in the external environment (greater need for capital, World Wars, economic devastation, politics, the rise of Communism) may better explain the differences in stock market development across common law and civil law countries.

These papers often note that the descriptions of common law and civil law in the "legal origins" literature oversimplifies reality and that in many instances common law countries are more regulatory than civil law countries (Roe, 2006). For example, the area of securities regulation possesses a strong regulatory hand whether we are examining it in common law or civil law countries (La Porta, Lopez-de-Silanes & Shleifer, 2006).<sup>11</sup>

---

<sup>7</sup> Later papers have suggested that common law systems tended to outperform civil law systems both in their countries of origin and even in countries where they had adopted one of these approaches. Further studies also suggested that it was the securities laws in particular that seemed to make a substantial difference in the outcomes as well (La Porta, et al 2006).

<sup>8</sup> One reason for this is that the common law expects judges to use more flexible rules (e.g., fiduciary duties) and this permits judges to police opportunistic behavior more effectively than in the civil law and this is something small investors (the likely victims of such opportunism) value. See La Porta, et al (1997), (1998).

<sup>9</sup> One might also interpret the "over-regulation" in the civil law as being regulation that benefits incumbents by making entry into domestic markets more difficult. This serves to weaken one of the other primary constraints on managers (and factors pushing toward better governance) – product market competition – because when firms face less competition then the consequences of their inefficient governance choices take longer to be visited upon them. By weakening the impetus for better governance from the product markets, civil law might tend to reinforce inefficiencies in governance and thereby also be a less attractive place for small shareholders to invest. See Khanna & Palepu (2006); Roe (2003).

<sup>10</sup> Some papers in the "legal origins" literature seem to suggest that it is statutory securities laws (rather than judicially enforced common law) that seems to spur stock market development. This suggests "legal origins" are not determinative. See La Porta, et al (2006).

<sup>11</sup> Indeed, both common law and civil law systems seem quite adept at being able to use (or borrow) tools and techniques from the other. I do not examine other areas of law that are relevant to investor

Further, it appears that the connection between common law legal origin and stock market development is of relatively recent vintage. In the early 1900s civil law countries had at least as well, if not better, developed stock markets than common law countries. Moreover, in terms of stock market development, it was after World War II that common law countries seemed to climb above civil law countries and even that trend seems somewhat short lived as the gap between civil and common law countries has diminished in recent times. This suggests that explanations that do not vary over time (e.g., “legal origins”) cannot explain what we have seen over the last 100 years (Rajan & Zingales 2001; Roe 2006).

Rather they argue that the variations in stock market development over the last 100 years are due to the effects of World Wars on the productive and economic base in Europe and the political struggles associated with Communism (Roe, 2006; Rajan & Zingales, 2001). These factors provide a stronger explanation for the variations in stock market developments than the legal origins thesis.

Other papers emphasize that although the law serves important functions, it has historically not preceded the initial development of stock markets, but rather followed it (Coffee, 2001a). For example, the development of US stock markets in the 20<sup>th</sup> Century was spurred by the need for capital to fund, amongst other things the expansion of Railroads. However, at that time there was limited availability of domestic capital and hence the US was in need of foreign capital. In theory, good law could help to assure foreigners that their investments were secure. US corporate law, on paper, was fairly good, but its enforcement was corrupt and haphazard. Yet, the markets grew because market players found other ways to provide the assurances that well enforced law might provide to outside shareholders.

For example, US investment bankers served as reputational intermediaries to encourage foreign investment (from Europe primarily) to come to the US. They (or the foreign investor) would often take a position on the issuer’s board both to monitor management and protect the public shareholders from predatory raiders. The former could be done directly and the latter because the investment bankers had their “ear” to the street and could “sense” an offer coming.

---

protection, such as broker regulation. See Jackson (200x). Of course, stock market development also depends on how comfortable shareholders feel in trading through brokers and other intermediaries.

In addition, the New York Stock Exchange (NYSE) played an important self-regulatory role. The NYSE had incentives to increase the number of investors who took part in the market and to maximize trading. Moreover, the fact that the NYSE faced intense competition in its early days would have made it more attentive to the needs of potential investors. When this is combined with its closed membership system one can see why the NYSE would be quite motivated to make itself a safe place for trading stock.<sup>12</sup> Thus, the NYSE's self regulatory measures also contributed to providing the assurances that investors needed to feel comfortable in investing in the US stock markets.

By the 1920s the US had fairly well developed markets even with fairly weak civil enforcement of corporate and securities laws. After the crash of 1929 we saw Federal regulation and enforcement step in. However, stock markets had developed well before these changes. These corporate and securities laws may have further helped the markets grow (or recover), but they did not appear essential to their *initial* growth.<sup>13</sup>

When reviewing these papers, which are more skeptical of the "legal origins" account, we find that a constellation of factors are important for stock market development. First, demand must exist for what stock markets can provide – external capital. This is more common when economic or technological changes require entrepreneurs to amass capital from many sources and alternatives to the stock markets are lacking (e.g., US Railroad expansion). Second, the supporting institutions for stock markets (functioning courts, adequate disclosure, methods of containing self-dealing and protecting minority shareholders) should be present or being put in place by legislators or private ordering (Black 2001; Coffee 2000, 2001a). Third, the political environment is conducive to (or, at least, will not thwart) the growth of stock markets (Rajan & Zingales, 2001; Roe, 2006). In these accounts law is important for protecting minority shareholders, but that has little to do with the division between common law and civil law regimes.

Thus, although scholars may debate the "legal origins" account, they generally agree that law is important to the development of stock markets. The question is how? More recent scholarship focuses on the enforcement of the law

---

<sup>12</sup> A closed membership system places a premium on keeping the system valuable because getting out of it (or selling one's interest) may not occur quickly or without impediments. See Coffee (2001a).

<sup>13</sup> Clearly property laws are critical to the development of stock markets (and markets in general), (Acemoglu, et al 2005) but as this paper focuses on corporate law and stock market development I will not address the role of property rights.



(Coffee (2008); Roe & Siegel (2008); Jackson & Roe (2008); Daines & Jones (2008)).<sup>14</sup> The general sense is that countries with active law enforcement, especially public enforcement (Jackson & Roe (2008)), in the corporate and securities area tend to have more developed stock markets.

Law enforcement is increasingly seen as critical because it provides investors with assurances about the credibility of firm disclosures by imposing sanctions for misleading or inaccurate disclosures (Daines & Jones 2008), protects investors' property rights against expropriation, signals government attitudes about acceptable governance standards and what areas may bear the brunt of enforcement scrutiny (Milhaupt & Pistor, 2008), and provides investors with a sense that they can have their grievances addressed in some efficacious manner (Coffee, 2008; Roe & Siegel, 2008; Jackson & Roe, 2008; Bhattacharyya & Daouk (2002)). These factors contribute to encouraging smaller investors to invest in firms leading to better stock market development. Further, even though the initial development of stock markets might not require immediate civil enforcement, continued growth usually does.<sup>15</sup>

Thus, a number of factors are important in facilitating stock market growth (e.g., enforcement, substantive rules, private ordering and norms). However, little analysis has focused on how stock markets grow in emerging markets. Given the phenomenal growth of some of these markets, it becomes important to examine how this has occurred and what insights that might provide on the theories discussed in this Part. Moreover, examining the development of stock markets in emerging markets is important for understanding the role of enforcement because that is usually where emerging markets tend to perform poorly relative to more developed markets. Moreover, one might expect some differences in the factors that were important to the development of stock markets in the US and the UK,

---

<sup>14</sup> There are things besides corporate law (or even law) that matter a great deal for how governance within a firm develops. For example, the efficiency of that governance device within a particular firm, the product and labor market competition the firm faces as well as the general economic environment. See Khanna & Palepu (2006).

<sup>15</sup> As the focus turns to enforcement, scholars have started examining what aspects of enforcement matter most. Although early studies identified private enforcement (civil litigation by investors) as being critical, more recent studies suggest that public enforcement (or a mix of public and private enforcement) may better correlate with stock market development (Jackson & Roe (2008)). However, whichever features of enforcement matter most, it seems clear that those countries with better enforcement (however measured) tend to have more developed stock markets. The question is why? There could be many potential explanations – better respect for rule of law, political considerations and so forth. Indeed, a very likely explanation is that countries with more developed stock markets have better enforcement because the players in the market lobby for it. Under this view enforcement and stock market development have a much more bi-directional relationship. Indeed, the historical evidence in the US and the UK suggests this (Coffee, 2002).

where the development was more “bottom up” (i.e., a result of private ordering then followed by legislative intervention) than in some emerging markets where the development of stock markets appears more “top down” (i.e., actively being pushed legislators and regulators). This paper engages examines these issues in one of the largest and fastest growing emerging markets – India.

### III. THE DEVELOPMENT OF CORPORATE GOVERNANCE IN INDIA – THE “PRODIGAL SON” RETURNS

Before discussing the state of the economy and corporate governance in India it is important to provide some basic details about India. India is a large country with considerable heterogeneity in its population and economic base. India has more than 20 official languages spoken by over 1 Billion people spread throughout roughly 30 states with significant rural and urban populations.<sup>16</sup> The geographic and climatic conditions vary greatly throughout India as do the range of its goods and services.

Politically, India is the world’s largest democracy with a variety of political parties and active elections. India possesses both a Central government and State governments. It is a Parliamentary democracy and is currently ruled by a coalition of over a dozen political parties with a resultant premium on consensus decision making.<sup>17</sup> Legally, India possesses a common law legal system, but has a detailed written Constitution that permits the operation of parallel legal systems. These include the Federal (i.e., Central) laws, State laws, religious laws (e.g., for family and inheritance matters) and local, often village, level courts.

Although this suggests a legal and government system of considerable sophistication and complexity, it is plagued by an inefficient judiciary, weak infrastructure and frequent complaints of endemic corruption. For many years these factors appeared to contribute to India’s rather paltry growth rate post-Independence. However, over the last two decades or so the Indian economy has been one of the faster growing economies. After the major economic liberalization that began in 1991, India’s economic policy has become much more market

---

<sup>16</sup> See Yasheng Huang & Tarun Khanna, ‘Can India Overtake China?’ *Foreign Policy*, July-August 2003; *The Economist* (2006); *Business Week* (2005) (article on China-India).

<sup>17</sup> There is no clear majority group (except arguably “Hindus” who do not appear unified under a particular political party). When there is no clear majority in a democracy, coalitions become more necessary. Moreover, when there are many different groups (i.e., high heterogeneity) one cannot simply ignore some groups because one may have to enter into coalitions with them later.

oriented and the country has witnessed fabulous growth rates.<sup>18</sup> For example, India has thousands of firms listed on over 20 domestic stock markets as well as an active private (not publicly traded) corporation sector.

India's economic success is now usually spoken of in the same breath with China's (and other hot emerging markets), yet it is India's stock exchanges that have grown so consistently and so much over the last decade. Indeed, the two major stock exchanges (the Bombay Stock Exchange and the National Stock Exchange) have seen their primary indices more than quadruple in the last decade. What might explain India's stock market growth when other hot emerging markets have yet to taste this level of stock market success?

One might conjecture that the corporate governance situation in India is different than in other places. Indeed, in the last decade India has engaged in an ambitious series of corporate governance reforms, which I discuss in this Part. As we shall see the saga of modern corporate governance in India is, in many respects, the story of the prodigal son – a promising start followed by a decline with much more recent attempts at redemption.

#### A. *Origins of Modern Corporate Governance in India (1866 to 1947)*

India, unlike a number of emerging markets, has had functioning stock markets since 1875 where much of the activity was organized in the form of joint-stock limited liability companies. From 1866 onwards there were many pieces of legislation governing corporate governance, trust activity, banking activity, and securities regulation (Bagchi (1972), Rungta (1970)).<sup>19</sup> Moreover, it appears that Indian Industry grew considerably during World War II because the Chinese and Japanese economies, which were in some sense competitors, were damaged by the war and by wartime activities on their territories.<sup>20</sup> Thus, by the time of

---

<sup>18</sup> In India, State Owned Enterprises are being privatized (on a case-by-case basis). Although the process has been erratic at times, it appears to be on somewhat more solid footing now.

<sup>19</sup> See the Indian Companies Act 1866; Indian Companies Act 1882; Indian Trusts Act 1882; Indian Companies Act 1913; Reserve Bank of India Act 1934; 1956 Indian Companies Act (in the process of being re-written); 1956 Securities Contracts (Regulation) Act (defines powers and conduct for stock exchanges); 1985 Sick Industrial Companies (Special Provisions) Act (bankruptcy provisions for financially distressed companies – also being re-written); 1992 Securities and Exchange Bureau of India (SEBI) Act (sets up SEBI – regulator of stock markets). For more discussion of the growth of Indian Industry since the beginning of the 20<sup>th</sup> Century see M.D. Morris, *The Growth of Large Scale Industry up to 1947*, in D. KUMAR (ED.) CAMBRIDGE ECONOMIC HISTORY OF INDIA VOL. 2 553 – 676 (1983). Note that even prior to the 1866 Act there were corporations in India, primarily in the Bengal (Calcutta) area.

<sup>20</sup> See SIR PURSHOTAMDAS THAKURDAS, J.R.D. TATA, G.D. BIRLA, SIR ARDESHIR DALAL, SIR SHRI RAM, KASTURBHAI LALBHAI, A.D. SHROFF & JOHN MATTHAI, THE "BOMBAY PLAN" FOR INDIA'S ECONOMIC DEVELOPMENT

Independence in 1947, India appeared to have well functioning stock markets, an active manufacturing sector, a large corpus of corporate and securities laws, and a well developed banking establishment (Chakrabarti (2005), Goswami (2003)). Although there were certainly corporate governance abuses, the general state of corporate governance and the overall economy in India placed it in an enviable position amongst many post colonial countries.<sup>21</sup> This position was, however, about to receive some serious setbacks.

### ***B. Independence to Liberalization (1947 to 1991)***

Following Independence the Indian government put in place a number of policies that had the effect of weakening corporate governance in India. This started with a series of Industrial Policy Resolutions which entrusted the state with much greater responsibility for managing the economy (Mohan & Aggrawal (1990)). The changes wrought by these resolutions included a much expanded state owned sector.<sup>22</sup> The government was to become the sole provider of many goods and services, which led to the nationalization of certain industries (in particular financial institutions) and the removal of private firms and competition from large sectors of the economy.<sup>23</sup> This would have reduced the competitive pressure to be efficient. Moreover, Indian state owned enterprises (SOEs) were not simply being run to maximize profits, but for a variety of additional reasons as well (Goswami (2003)). In light of this, it is unsurprising that such firms would not focus their corporate governance on efficiency.

This was accompanied by a series of enactments that worked as entry barriers to certain markets and to investment. First, laws were passed that required industrial enterprises to obtain a number of licenses from various government agencies to conduct business or to expand capacity (commonly known as the “license raj”) (Goswami (2003)). The requirement to obtain the government’s approval provided opportunities for rent-seeking and corruption that likely led to a less competitive environment for many Indian businesses.

---

(1944). This is generally consistent with Roe’s account of the importance of economic devastation in one’s own territory (Roe, 2006).

<sup>21</sup> See Goswami (2003).

<sup>22</sup> Some of these changes bear considerable similarity to the suggestions laid out by the leading Indian Industrialists in the 1944 Bombay Plan. The Plan was to be a blueprint for economic growth in India and many of its suggestions seem to have been adopted by the first few Indian governments.

<sup>23</sup> There were also some industries where only the state could start new firms (Goswami (2003)). There appeared to be a belief that the private sector, domestic and foreign, could not be relied upon to provide these goods and services and that they may have incentives that do not enhance social welfare (Chakrabarti, (2005); Bombay Plan (1944)).

Second, the government erected large trade barriers and tariffs, imposed limits on how much stock a foreign entity could own in an Indian enterprise, and required firms to purchase their goods from primarily indigenous producers (Mohan & Aggrawal (1990), Goswami (2003)). This insulated domestic firms from foreign competition and, when combined with the extensive licensing requirements, insulated domestic firms from much further domestic competition. The lack of competition would have benefited incumbents, but would also have hindered further growth in corporate governance by reducing the competitive pressure to be efficient.

This was compounded by how private sector firms were capitalized and the incentives of the various capital providers to monitor management. The primary source of capital for many Indian firms was debt capital. This was made available by the state through a variety of state owned and operated development finance institutions (DFIs) (World Bank Report (2005), Chakrabarti (2005), Goswami (2003), Bhasa & Jha (2007)). The employees of the DFIs were not assessed based on whether the firms they provided funding to made a profit, but rather on the total amount of loans that had been made. This, of course, created an incentive to maximize the amount of loans rather than providing loans to businesses with viable business plans. DFIs then had little incentive to monitor management. Indeed, the DFIs often favored management due to a variety of reasons including corruption and political gain.

Although the DFIs were often the primary credit providers, other creditors did exist and could have had some incentive to monitor management. This was, however, hampered by the glacial speed of India's bankruptcy process. There were inordinate delays in the process of restructuring and liquidating a firm (e.g., it could easily take 10 years to liquidate a firm) and this would have placed non-DFIs creditors in an unenviable situation (Anant & Goswami (1995), Goswami (1996)). Indeed, it was not very common for private creditors to provide credit to anyone but large and very well known firms or firms that had government guarantees. Thus, these creditors were unlikely to exercise real oversight over management.

Even if creditors could not or did not monitor management, perhaps shareholders could. Here once again there were problems. First, the primary providers of equity capital were the DFIs. Although most DFIs would invest primarily in the form of debt, they might also invest in the form of equity when their internal debt ratios would prohibit them from investing any more as creditors. Indeed, for many companies the DFIs had collectively well over 50% of

the equity stock. However, the DFIs had, as before, little incentive to act as careful monitors of management and used to routinely appoint nominee directors to the boards of these corporations that would rubber stamp management decisions (World Bank Report (2005), Goswami (2003)).

If the DFIs did not exercise oversight, then what about other minority (non-management) shareholders? There were provisions in the Companies Laws for minority shareholders to raise oppression and mismanagement concerns at various adjudicative fora.<sup>24</sup> However, they were unlikely to have their grievances redressed for a number of reasons (Goswami (2003)).

First, the Indian judicial system was full of delays and years could pass before such litigation would be adjudicated. Second, there appeared to be many irregularities in the share transfer and registration process which would have further delayed minority shareholders in bringing their cases. Third, the disclosure of ownership structure and related party transactions was very opaque in India making it even harder for minority shareholders to achieve redress. This was exacerbated by the very high tax rates for corporations and individuals, which led to a tremendous amount of tax evasion achieved by devising highly complicated cross-holding structures. This made ownership structure even more opaque to minority shareholders. Finally, even if someone tried to buy up shares in the corporation from the DFIs the government could block share transfers that might result in a change in the board that the government considered “prejudicial to the interest of the company or the public interest”.<sup>25</sup> Given that government (via the DFIs) tended to vote with management one can easily see how this would lead to entrenchment of management and little scope for effective oversight by other shareholders.

Of course, even if non-management shareholders and creditors exercise little oversight it may be that management and promoters had incentives aligned with maximizing wealth. Here too capital structure played an invidious role. Because the DFIs provided so much of the capital (both in debt and in equity) the promoters could maintain control by providing only 3% of a firm’s capital (Chakrabarti (2005), Goswami (2003)). With so little invested in the firm the promoters and management had incentives that diverged quite widely from the rest of the shareholders. Indeed, the prospect for self-dealing and moral hazard would loom large in this environment.

---

<sup>24</sup> Indian Companies Act 1956 section 209.

<sup>25</sup> Indian Companies Act 1956 section 309.

Such a system should have led to considerable looting by management and many failed companies. Indeed, it did, but the system was insulated from some negative financial and employment consequences due to the slow bankruptcy process and the fact that the state could (and did) takeover failing businesses and keep them afloat to maintain employment. The employment dislocation that would otherwise follow such policies did not immediately eventuate, but at the cost of increasing the effective debt burden for the state (Anant & Goswami (1995)).

Thus, by 1991 the Indian corporate scene had changed considerably from its pre-Independence situation. For SOEs the lack of competition and little profit incentive contributed to the inefficiency of the enterprise and of its atrophied corporate governance. For private firms corporate governance was ineffective for a number of reasons. First, the DFIs as large shareholders and creditors played little to no monitoring role given how their incentives were set up and the political background against which they were to act. Second, the non-DFI creditors could exercise only limited oversight given the very slow pace of bankruptcy proceedings in India. Third, minority shareholders (non-DFI shareholders) faced considerable obstacles in enforcing their rights. Fourth, promoters could start firms by putting up only the smallest sliver of their own capital. When this is combined with the ineffective oversight by other parties the potential for mismanagement and fraud becomes quite large. Moreover, these private firms faced little competitive pressure to improve their efficiency because of the “license raj” system, which limited domestic competition, and the high trade and other barriers limiting foreign competition. Finally, the employment dislocation that might have been caused by very inefficient management leading to failed firms was not felt in its entirety because the state could take over failing firms and keep their work force employed. This would have reduced the political cost of supporting inefficient management.

This is a recipe for dysfunctional corporate governance and that is precisely what India had. From the outside India had the laws and the legal system to enforce corporate governance but the operation of the system, inconsistent disclosure, and largely ineffective boards of directors led it to be a failing system of governance. Indeed, Indian firms looking for capital had to rely primarily on internal sources or on the capital provided by the DFIs (Bhattacharyya & Rao, 2005, World Bank Report, 2005).

### ***C. Liberalization and Corporate Governance Reform (1991 to present)***

The sheer weight and cost of the overall economic and regulatory system came crashing down on the Indian economy in 1991 when the Indian government, in response to a financial crisis, embarked upon a general program of liberalization. Liberalization was to take the form of selling off some of the SOEs and beginning to sell off or rationalize the state's interests in other firms. Further, the DFIs were now to be assessed on "bottom line" measures rather than the amount of loans sanctioned.<sup>26</sup> Moreover, trade barriers were to be reduced, foreign investment permitted (and even encouraged) and the "license raj" to be eased thereby permitting for increased domestic and foreign competition (Goswami (2003), Krueger (2003)). Following this the government created the securities market regulator – the Securities & Exchange Board of India (SEBI) in 1992 – and slowly granted it increasing powers and the mandate to regulate the stock markets in India.<sup>27</sup> This was also significant because SEBI could take on an adjudicatory role and thereby relieve some pressure on the court system and provide more timely resolution of disputes.

It is against this backdrop that corporate governance reform would develop in India. Although the mid-1990s saw the first incursions into reforming the stock markets and governance,<sup>28</sup> the watershed event is generally perceived to be SEBI's promulgation of Clause 49 of the stock exchange listing agreement in 2000.

The first steps toward Clause 49 came in 1998 when the Confederation of Indian Industry (CII) – a large Industry association – proposed a voluntary code of corporate governance for Indian firms. This was followed in quick measure by SEBI forming the Kumar Mangalam Birla Committee (KMBC) to suggest changes in the listing agreement of the stock exchanges to address corporate governance concerns. The KMBC's draft set of recommendations came out on October 1, 1999 and became effective as Clause 49 of the listing agreement with the Exchanges on February 21, 2000 – a stunning 5 months later. Firms failing to meet the

---

<sup>26</sup> Indeed, the DFIs were no longer provided the kind of subsidized access to funds they had in the past and they were sometimes merged with private entities (World Bank Report (2005)). The primary DFIs before 1991 were: - IFCI, ICICI, IDBI, UTI, LIC, GIC and Public Sector Banks. Now there are 3 sets of Institutional Investors – the DFIs, new private sector Mutual Funds, and Foreign Institutional Investors.

<sup>27</sup> See Securities & Exchange Board of India Act 1992.

<sup>28</sup> The reforms started almost with the creation of SEBI in 1992, but some of the key regulations were the SEBI Takeover Code 1997 (dealing with acquisitions of control primarily) and the SEBI Disclosure & Investor Protection Guidelines 1999 (addressing public issuances of securities).



requirements of Clause 49 could be delisted.<sup>29</sup> The details of Clause 49 are provided in Appendix 1, but a quick overview is provided below.

Clause 49 had a number of requirements and recommendations and it provided a phased in implementation schedule wherein certain firms (e.g., Group “A” firms or larger firms) were expected to comply earlier than mid sized firms which were expected to comply earlier than smaller firms. Clause 49’s requirements included:

- (i) minimum percentages of independent directors (50% or 33% depending on whether the Chairman was an executive director),
- (ii) tightening up the definition of “independence”,
- (iii) mandating the number of board meetings per year,
- (iv) developing a code of conduct,
- (v) imposing limits on the number of directorships a director could simultaneously hold,
- (vi) enhancing the power of the audit committee by requiring financial literacy, experience and independence of its members, and by expanding the scope of activities on which the audit committee had oversight,
- (vii) certifications by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of financials and overall responsibility for internal controls,
- (viii) enhanced disclosure obligations (on many things including accounting treatment and related party transactions), and
- (ix) enhanced requirements for holding companies when overseeing their subsidiaries.

These changes appear aimed at making boards and audit committees more independent, powerful and focused monitors of management. Moreover, the enhanced disclosure would aid institutional and foreign investors in monitoring management as well. Clause 49 was received with much fanfare and has been the subject of many conferences, events and debates on its reach, application and interpretation.<sup>30</sup>

---

<sup>29</sup> Now there is the possibility of financial penalties from Section 23 E of the Securities Contracts Regulation Act 1956 (as amended in 2004).

<sup>30</sup> There is a website dedicated to Clause 49, see <http://www.clause49.com/clause49.htm>.

Following Clause 49 a number of further committees were formed which led to further changes in the listing requirements (e.g., Y.H. Malegam Committee, Narayana Murthy Committee, Naresh Chandra Committee).<sup>31</sup> Some of these changes came into effect in 2004. Also, during 2004 the Indian government amended the Securities Contracts (Regulation) Act 1956 wherein section 23E now imposed larger financial penalties for violations of the listing agreement (up to Rs. 25 crore (roughly US\$ 6,250,000) for a violation).<sup>32</sup> This was a significant increase in penalties from the initial penalty of de-listing for violations of Clause 49.

By 2005 amendments were being proposed to the Statutory Companies Law based on the J. J. Irani Committee's (2005) recommendations.<sup>33</sup> If adopted, the statutory law would permit greater customization and self regulation (e.g., requiring shareholder approvals for executive compensation). Moreover, there would be greater protections for smaller shareholders, especially in merger transactions. Finally, the process of enforcement is to be streamlined, the bankruptcy system upgraded, and the actual legal provisions rationalized and simplified (eliminating redundancies and so forth). The changes will apply to all firms in India (not just those listed on the exchanges as with Clause 49). The proposed changes are summarized in Appendix 1 and compared to the changes wrought by Clause 49. These changes are not inconsistent per se with Clause 49 given that Clause 49 only applies to a subset of firms (listed firms) subject to the Irani committee's recommendations.<sup>34</sup>

Since 2005 there has not been much in the way of changes to either the listing agreement or the Statute, but in September 2007 SEBI initiated its first enforcement and investigation proceedings against firms for violations of Clause 49.<sup>35</sup> It is noteworthy that the first enforcement actions were brought nearly seven years after the promulgation of Clause 49 and to date no penalties have been imposed. Finally, just recently the Indian Cabinet has approved the Irani Committee's recommendations and statutory law changes are thus visible in the near horizon.<sup>36</sup>

---

<sup>31</sup> See Murthy Committee (2003); Chandra Committee (2002), Malegam Committee (2003).

<sup>32</sup> Inserted by Securities Laws (Amendment) Act, 2004, S.11 (which takes effect from Oct. 12, 2004).

<sup>33</sup> Moreover, the corporate governance of banks was reformed as well. Chakrabarti, (2005). In banks the system of nominee directors is being phased out and the banks use the CAMELS system (Capital Adequacy, Asset Quality, Management, Earnings Liquidity and Systems and Controls). See id.

<sup>34</sup> Listed firms raise capital from the general public and that may raise additional concerns compared to private firms.

<sup>35</sup> See Ashish Rukhaiyar, *Navratnas Join Listing Rule Violators*, THE ECONOMIC TIMES, 13 Sept., 2007; *SEBI Pulls up 20 Clause 49 Violators*, THE ECONOMIC TIMES, 12 Sept., 2007.

<sup>36</sup> See *Cabinet Approves Companies Bill*, THE TIMES OF INDIA, August 30, 2008.

There are many important and perhaps remarkable features of the Clause 49 reform process. The first is that the reform process was initiated and supported by private industry (i.e., the CII) rather than triggered by an Enron-like scandal (Goswami (2003)).<sup>37</sup> This is somewhat unusual because governance reform tends to place constraints on what managers and controlling shareholders can do. Given that these people make up the power structure of Indian Industry it seems odd that they would support placing constraints on themselves.

However, in India, industry pushed for governance reform because access to capital was necessary to take advantage of the opportunities created by liberalization and to stay ahead (or at least with) the competition.<sup>38</sup> Obtaining capital from domestic and foreign investors would have been difficult without some greater assurances (given the poor track record of the capital markets since Independence and the debilitated state of governance).<sup>39</sup> Moreover, given the likely low level of interest (and perhaps available capital) from domestic investors, industry may have had to approach foreign investors for the bulk of their funding initially. The CII voluntary code in many respects appears designed to attract foreign investors to Indian firms as many of its provisions were based on “best practices” at the international level.<sup>40</sup>

However, the voluntary code was not perceived to have generated a very high level of foreign investor interest. Enacting the CII code as law might be necessary to bolster the credibility of governance reform. Indeed, we see CII lobbying SEBI to enact some governance reform less than a year from the announcement of its voluntary code. Presumably, making governance part of the law would enhance its credibility and probably provide some enforcement for it. Thus, the corporate governance reform movement was motivated by a desire to raise capital from foreign investors to fund investment in new business opportunities or to enhance chances in current endeavors. With industry, the primary opposition to reforms normally, supporting them it is not surprising that the reforms came swiftly. Reform was also supported by the increasing presence

---

<sup>37</sup> There were some scandals in the Indian markets, but none that seemed to trigger the Clause 49 reform process. The stock market scandals often involved misdealings by brokers and traders rather than the more standard corporate governance concerns. See Goswami (2003)..

<sup>38</sup> See Goswami (2003), Chakrabarti (2005).

<sup>39</sup> See Goswami (2003).

<sup>40</sup> This bears some similarity to how the stock markets in the US developed (Coffee, 2001a). However, in India the markets developed after the law was enacted and not due to voluntary measures (like the CII code) suggesting that the law did matter more to the initial development of the markets in India than in US [Discuss more].

of foreign investors, the Indian financial press being quite active, and the desire to access US capital markets (Goswami (2003)).

Another important feature of the Clause 49 reform process was the gradual escalation of sanction severity. Initially, the penalty for non-compliance was de-listing (2000) then some years later more severe financial penalties became available (2004) and then finally enforcement actions some years later (2007-08). This is perhaps not too surprising.

Starting with the less severe penalties (i.e., de-listing) may have dulled opposition to the reforms. Moreover, listing requirements are generally enforceable only through SEBI and the Exchanges which can utilize enforcement discretion thereby softening the impact of the changes. One might, of course, wonder what opposition was there to the reforms given CII's active encouragement of them? However, simply because CII supported these reforms does not mean that *all of Indian Industry* was in favor of them. For example, the faction(s) that had the critical say in CII may have favored reforms, but there may have been some who were not as enthusiastic about them. In light of this, a strategy of first changing listing requirements looks very much like an attempt to "test the waters" in a relatively low cost way and then if the change "sticks" to proceed with statutory changes thereby providing firms with sufficient time to adapt before penalties became more significant.<sup>41</sup> Such a strategy is less likely to encounter political opposition, provides time for incumbents to adapt, and may still provide enough assurances to encourage foreign investment in India.

This leads to another interesting part of the process – the weak sanctions and enforcement in India stand in contrast to many other countries that engage in law reform and start with *strict enforcement* to attract investors. One suspects these countries must do this because the motivation for the reforms is some large scale fraud (e.g., Enron) which may then necessitate visible enforcement actions to restore investor confidence. However, in India visible enforcement actions were probably not as necessary to attract investors because such scandals were not the immediate reason for promulgating the reforms. Indeed, industry support for the reforms may have even lessened the pressing need for enforcement to convey that changes in governance were credible.

---

<sup>41</sup> The Irani committee's recommendations may reflect a different environment than when Clause 49 was enacted. India attracts much more capital now than it did before Clause 49 (indicating that the marginal gain from governance reform now may not be as large) and there are many firms who have had difficulty in complying in a timely manner with Clause 49 indicating that further reform may be fairly costly on top of the reforms in Clause 49.

#### D. *Evidence on Responses to the Reforms*

Having described the Clause 49 reforms the next natural question becomes what effects have these reforms had? There are a handful of studies examining the impact of corporate governance reforms in India. The tenor of these studies is that the Clause 49 reforms were received positively by the market and were generally effective at helping to raise capital for Indian firms.

An early study by Bhattacharyya and Rao (2005) examines whether the adoption of Clause 49 predicts lower volatility and returns for large Indian firms. They find insignificant results for volatility and mixed results for returns.<sup>42</sup>

Black & Khanna (2007) conduct an event study of the adoption of Clause 49. They rely on the phased implementation schedule, in which “large” firms were required to comply before “small” firms, and report positive returns to a treatment group of large firms relative to a control group of small firms, around the first important legislative announcement.

Balasubramanian, Black & Khanna (2008) conduct a detailed survey of Indian firms to assess whether better governance practices are correlated with better firm performance (e.g., Tobin’s  $q$ ). Their survey obtained responses from 370 firms (a 73% response rate) in 2006. Their findings are that better governed firms tend to have higher Tobin’s  $q$ .

Dharmapala & Khanna (2008) examine whether the firms subject to Clause 49 performed better (as measured by Tobin’s  $q$ ) than unaffected firms after it became known that serious financial penalties might attach for violations of Clause 49 (which was in 2004). They find that the firms affected by Clause 49 had higher Tobin’s  $q$  right after 2004. This suggests that the threat of serious financial penalties had a significant impact on firm value. Indeed, this paper provides compelling evidence of the reforms *causing* increases in firm value in India and

---

<sup>42</sup> The authors examine volatility and returns relative to a cap weighted index composed largely of the firms they study. Thus, they are examining in essence whether there is a difference in volatility or returns between an equal weighted and a cap weighted portfolio of large firms. Another concern is that firm size may predict both volatility and returns for many reasons besides Clause 49. They also examine if firm betas change post adoption of Clause 49. Why they expect betas to change is unclear.

that the enhanced sanctions/enforcement provisions in 2004 may have had a more significant impact than the substantive laws reforms enacted in 2000.<sup>43</sup>

Of course, other measures might be used to assess overall governance practices in India. Minority shareholder expropriation is an important issue in India with a large number of controlled firms. Khanna, Kogan and Palepu (2006), study instances of minority shareholder expropriation by Indian firms and Bertrand, Mehta and Mullainathan (2002) provide evidence on tunneling within Indian business groups. Dharmapala & Khanna (2008) examine whether the tunneling risk within Indian business groups changed after the Clause 49 set of reforms. Their initial evidence indicates that tunneling dropped to very low levels around the announcement of the substantive reforms (1999-2000) and has more or less stayed there since then. Of course, there are other methods of insider expropriation besides tunneling within business groups, but those are not measured by the Dharmapala & Khanna (2008) study.

Thus, the Indian evidence suggests that Clause 49 has had positive effects on the Indian markets. That raises an important question – why? What features of Clause 49 have been important? Given that most of the Clause 49 reforms were already present in the CII voluntary code it would appear that it was not simply the actual provisions *per se* that were valuable, but the threat of enforcement (and perhaps legitimacy or signals) the law provided via Clause 49. If the provisions themselves were all that mattered then industry would have been able to raise the desired level of capital with the voluntary code. The presence of the same provisions in a law seemed to matter quite a lot, suggesting that enforcement was critical. I now turn to examine this more closely.

#### IV. WHY MIGHT ENFORCEMENT MATTER?: INSIGHTS FROM INDIA

At first blush, the Indian experience raises questions about the connection between law enforcement and stock market development. Although Indian stock markets have had phenomenal growth and seemed to respond positively to the announcement of the Clause 49 reforms,<sup>44</sup> it is quite clear that there has been virtually no enforcement of Clause 49, substantial non-compliance with its

---

<sup>43</sup> The similarity of Clause 49 to Sarbanes-Oxley (SOX) is striking, but the apparently beneficial effects of Clause 49 in India do not mean that SOX is similarly beneficial in the US – that would depend greatly on institutional context too.

<sup>44</sup> Although this growth cannot be attributed solely to Clause 49, but clearly those reforms did not seem to impede growth in the Indian markets.

requirements and that even if enforcement had occurred Clause 49's initial sanctions would not have necessarily benefited shareholders.

For example, SEBI's first enforcement actions under Clause 49 occurred only in September 2007 – some seven-and-a-half years after its enactment.<sup>45</sup> During this period it was well known by SEBI and the market that many, if not most, listed firms were not complying with its requirements.<sup>46</sup> Indeed, there were a significant number of firms that *admitted* they did not meet some of Clause 49's easy to measure requirements (Balasubramaniam, Black & Khanna, 2008). Moreover, there was no private enforcement under Clause 49 because it could only be enforced by SEBI. Thus, for the first seven-and-a-half years there was no enforcement from any quarter and significant non-compliance.

In addition, the penalties on the books for violating Clause 49 when it was initially enacted were unlikely to generate much shareholder confidence in the markets.<sup>47</sup> De-listing may have some deterrent effect, but it does not matter much for the roughly 85% of Indian firms that do not trade frequently.<sup>48</sup> In addition, if this sanction were ever visited on a firm it would hurt its shareholders even more because they would find it difficult to liquidate their interests in a de-listed firm. Finally, the more severe financial penalties were made available for violations of Clause 49 in 2004, but those have yet to be used. This stands in contrast to law

---

<sup>45</sup> See *SEBI Cracks Down on ONGC, 4 PSUs for Clause 49 violation*, THE INDIAN EXPRESS, Sept. 12, 2007; Special Correspondent, *SEBI Cracks the Whip - Violation of Corporate Code Under Lens*, THE TELEGRAPH, Sept. 11, 2007; *SEBI Kicks off Probe Against 20 cos*, THE TIMES OF INDIA, Sept. 12, 2007; Ashish Rukhaiyar, *Navratnas Join Listing Rule Violators*, THE ECONOMIC TIMES, 13 Sept., 2007; *SEBI Pulls up 20 Clause 49 Violators*, THE ECONOMIC TIMES, 12 Sept., 2007. These articles discuss the SEBI announcement that it had started adjudicatory proceedings against some 20 firms (including 5 government firms – Public Sector Undertakings) for violations of Clause 49's requirements.

<sup>46</sup> See *No Exemption on Clause 49*, THE ECONOMIC TIMES, 31 August 2006 (noting that the SEBI Chief M. Damodaran thought compliance with Clause 49 was very low); *SEBI Wants SEs to Act Against Firms Defying Clause 49*, THE FINANCIAL EXPRESS, 31 August 2006; R. Bijith, *Half of BSE listed Cos Yet to Comply with Clause 49*, THE INDIAN EXPRESS, January 3, 2007. Balasubramaniam, Black & Khanna (BBK) (2008) find there is generally good compliance with Clause 49's primary requirements by 2006. For some provisions well over 70% of the firms BBK surveyed complied with the requirements. The survey responses were based on self-reporting from firms and some information from independent sources. It is possible that firms who had better governance were more likely to respond, although there were a number of firms who admitted they were not complying with the law. It is also possible that firms complied to advertise good governance because they thought the market valued it. Of course, if that was the case then one wonders why firms did not comply with the Industry's voluntary code, but did comply when the law required it without serious threat of enforcement.

<sup>47</sup> The severe financial and other penalties available for violation of listing requirements were embodied in the 2004 Amendment to the Securities Contracts Act and hence came well after the adoption of Clause 49 in early 2000. No penalties have yet to be imposed under Clause 49.

<sup>48</sup> See Prowess database maintained by the Center for Monitoring the Indian Economy.

changes in the US (e.g., the 1933 and 1934 Securities Acts and Sarbanes-Oxley) which were enforced quite soon after their enactment (Daines & Jones, 2007).<sup>49</sup>

This raises a puzzle: why did Indian law reforms appear to be associated with and indeed cause substantial growth in the Indian stock markets (Dharmapala & Khanna 2008) when enforcement of those laws was very weak?<sup>50</sup> To answer this question one needs to identify who was attracted to invest (and help grow) the Indian stock markets after the reforms.

It seems fairly clear that Foreign Institutional Investors (FIIs) were critical and their level of investment in the Indian stock markets increased after the reforms.<sup>51</sup> The perception appeared to be that better governance and governance reforms were valuable to US-based FIIs who often have a policy to invest in countries (and firms) that have good corporate governance laws and practices (e.g., CalPERS, Fidelity and others).<sup>52</sup> Why, however, would FIIs be willing to invest in India if these reforms were hardly enforced?

To examine this question we need to know how governance reform could benefit FIIs. When FIIs invest we expect that they will generally be concerned about (i) investing in entities producing good returns, (ii) investing in places where their property rights are generally secure and (iii) investing in places where

---

<sup>49</sup> It might seem surprising that a provision that had so much support (even from its natural opposition, CII) would have such weak enforcement. However, one must keep in mind that even when Industry supported the reforms it might have anticipated that the application of the reforms would be grandfathered in with the smallest firms being given substantial time to comply. This may have been one of the understandings that allowed for easy passage of the reforms. This is not so surprising. After all, the reforms would have been relatively new to many firms and to expect strict enforcement so early might well have generated a backlash. This backlash would not have provided much compensating benefit to regulators because at that time there was no developed large shareholder constituency in favor of better governance. Indeed, the *hope* was that after the reforms that constituency would develop following the lead of FIIs whose investments in India could help to attract the smaller, more passive, investors. Once these investors are present the constituency for better governance and enforcement would become present.

<sup>50</sup> One response is that Clause 49 may not have been a terribly important change to the Indian markets, relative to the other legal and economic changes (e.g., SEBI Takeover Code, Liberalization, growth in many sectors). Although a plausible explanation, there is evidence to suggest that the market thought Clause 49 was important when announced (Black & Khanna, 2007) and there have been many conferences, newspaper articles, debates, and events in India on governance and Clause 49 suggesting that it was perceived to be important as well. However, the underlying message of this possibility is that governance reform is a second (or lower) order factor in the growth of stock markets. This is certainly plausible, but that does not change the pattern of investment from FIIs.

<sup>51</sup> Indeed, the reforms were enacted with the objective of attracting capital (especially foreign capital) to India. For further discussion of FII investment see Dharmapala & Khanna (2008).

<sup>52</sup> At the time, capital was most likely to come from foreign investors rather than domestic ones. Indeed, one of the attractions of Clause 49 requirements was that they matched what most foreign investors would have come to expect over the years as indicia of good governance.



they can exit their investments fairly quickly (liquidity).<sup>53</sup> Changes in governance could influence all of these and hence change the risk-return relationship at the margin sufficiently to unleash FII investment into India. However, governance changes could be made voluntarily by firms. Thus, for the law to matter its enforcement is what probably matters most. The strategy in this Part is to identify how the law reforms might benefit FIIs, how the lack of enforcement influences that and then assess what facts or evidence are available in India to support these potential benefits.

Generally, one can envision the law influencing FII behavior in at least two ways. First, the law threatens sanctions for misbehavior that will induce people to behave in the desired manner (the deterrence rationale). This involves both the presence of sanctions associated with violations of the law and their imposition when needed (i.e., enforcement). Second, the law may influence behavior by signaling a new norm or government policy that has come into existence or the law may be used to generate or reinforce a new norm by establishing a new way(s) of doing things.<sup>54</sup> I examine both rationales in the next few sections.

#### *A. Attracting Foreign Institutional Investors Through Deterrence Related Concerns*

In this section I focus on how the reforms might have benefited FIIs as shareholders and what effects the lack of enforcement may have had on those benefits. Where available I examine these theories with facts and data from India.

##### *1. Substantive Rules*

Clause 49's requirements for enhanced disclosure, greater shareholder rights and board independence could directly benefit FIIs as shareholders. These reforms may provide FIIs with information that can be used to monitor management and the firm's performance as well as seek legal redress through the courts. Of course, most of these benefits require enforcement of the law, which we know is currently missing in India. However, for purposes of describing a benchmark I canvass how the reforms could arguably benefit FIIs as shareholders and note where they may warrant skepticism.

---

<sup>53</sup> Of course, FIIs will compare investment opportunities across firms and countries. See Chari & Gupta (2007). The critical issues are what FIIs consider critical in making decisions.

<sup>54</sup> See McAdams (2000), (2007).

First, it is not always clear *a priori* why FIIs would need better governance laws or rules to assure themselves that the firm's managers or controllers will not behave opportunistically. FIIs are sophisticated players who can monitor for themselves (given basic contract enforcement in India) and could demand information or a board seat before investing – as they did in the early growth of US stock markets.<sup>55</sup> In any case, because FIIs are repeat players they can have an impact on firms by denying funding in the future and hurting the reputation of Indian firms who have behaved poorly.<sup>56</sup>

In addition, there is evidence that FIIs primarily chase returns rather than better governance (see Chakrabarti, Money & Finance, 2002). Indeed, in spite of occasional public statements to the contrary, the most recent survey by the World Bank of Institutional Investors in India (World Bank, 2005) finds that few of them rate governance as an important factor in their decision to invest.<sup>57</sup> Moreover, it also appears that if a governance issue was likely to arise, most institutional investors would not be enthusiastic about intervening, but rather would prefer to sell their shares.<sup>58</sup>

How then might FIIs benefit as shareholders from such reforms? One explanation is that the ability of FIIs to protect themselves by denying future opportunities to firms is limited in that it does not work well with firms that are engaged in fraudulent activities as they may not intend on being repeat players – they simply want to take the money and run.<sup>59</sup> Second, requiring the provision of information from all firms in a particular format may have the advantage of standardizing the information thereby enabling easier comparability across firms (which reduces information processing costs for FIIs).<sup>60</sup> Third, FIIs may benefit from the added credibility the law provides to firm disclosures by, for example,

---

<sup>55</sup> A board seat permits the director to have access to “softer” information and information related to the future that may not be available in written documents or disclosures. See Coffee (2001a).

<sup>56</sup> Moreover, the threat of being denied future capital may resonate more with Indian firms, which are usually controlled by a family or group, than with US firms which are more often run by managers without a controlling block. US managers may not internalize the costs of losing these future capital raising opportunities as well as Indian managers/owners.

<sup>57</sup> Although FIIs consider governance more important than other institutional investors, governance still did not occupy a critical role in their investment decisions. Studies do find that better governed firms tend to have higher amounts of FII investment. Perhaps, more profitable firms are better governed and it is the profitability, rather than governance, that may be motivating the FIIs to invest. See Chari & Gupta (2007).

<sup>58</sup> [Collecting cites].

<sup>59</sup> Cf. Khanna (1996). Although plausible, one suspects FIIs should be rather good at determining who is likely to be fraudulent and who is not (the absence of a viable business plan and may be tell tale signs).

<sup>60</sup> See Choi & Pritchard (2008). Although these benefits are certainly plausible, it seems likely that FIIs could think of ways to address these issues too (e.g., personal guarantees, staggered funding).

imposing sanctions for inaccurate or misleading disclosures (Daines & Jones, 2007). This reduces the verification costs that FIIs expend before relying on firm disclosures. However, the enhancing credibility argument has somewhat less appeal in the Indian context. Firms were already subject to liability for inaccurate disclosures before Clause 49 (a position not enhanced or changed by Clause 49).<sup>61</sup> In other words, the credibility of Indian firms' disclosures about governance practices, attributable to the liability risk for misleading disclosures, was essentially the same before and after Clause 49.

Thus, there might have been only a few ways in which the substance of the reforms was important to FIIs (e.g., standardization of information, protection against fraudulent but non-repeat players and potentiality enhanced credibility of firm disclosures). However, the absence of enforcement largely undermines them. For example, absent enforcement the credibility of disclosures does not improve and comparability of information across firms may suffer. If so, then we need reasons why FIIs might consider reforms useful even if they were not enforced.

## 2. *Reforms Valuable Even if No Enforcement?*

The reforms could have effects without active enforcement on a number of potential theories. Let us begin to examine them.

### a. FIIs were duped

One explanation is that when the reforms were enacted FIIs might have erroneously thought they would be enforced soon. I do not consider this a convincing explanation. FIIs (often large sophisticated institutions) are probably not so naïve to believe that just because a new rule was promulgated that it will be immediately enforced. This is even more unlikely in India and other emerging markets where there is a sense that law enforcement is weak, potentially corrupted, and slow.<sup>62</sup> In addition, the governance reforms had a phased in

---

<sup>61</sup> See Indian Companies Act 1956, section \_\_\_\_.

<sup>62</sup> Further, most FIIs would have realized that the most severe penalty under Clause 49 at the time of its adoption (i.e., de-listing) would not frighten most Indian firms (due to infrequent trading). Financial penalties were added later (in 2004), but even they have not been imposed as yet.

Of course, FIIs may not have been interested in investing in smaller firms, but the point is that it would have been clear that de-listing would only work as a partial deterrent. However, for the firms that do trade frequently, de-listing might be a serious threat. One might argue that this would lead these firms to meet these requirements. However, the results of the corporate governance survey (Balasubramanian, Black & Khanna, 2008) suggest that there are a number of firms that trade fairly frequently that still do not meet (in 2006) some easily observable features of Clause 49.

implementation schedule (large firms were to comply earlier than smaller firms) so FIIs knew that it might be sometime before enforcement would occur for smaller firms. In light of this, it is implausible that FIIs thought enforcement would be swift or severe.<sup>63</sup>

**b. FIIs correctly anticipated delayed enforcement**

FIIs might have anticipated that enforcement would not occur immediately, but rather in the medium term. At the margin this may change the risk-return relationship sufficiently to induce FII entry. In many emerging markets, and especially in India, it is common for a law to be announced and not enforced for a few years. This may be because immediate enforcement could result in a political backlash from local players or because the government wants to provide local firms with time to implement the needed changes or for a variety of other reasons.<sup>64</sup> In other words, the initial enactment may signal a commitment to have enforcement in the medium term, although not immediately.

However, for delayed enforcement to trigger FII interest in investing in India at least two things must happen. First, FIIs must be *willing* to wait for enforcement for a few years (yet still desire enforcement in a few years) and second, FIIs must *believe* the government will, in the next few years, begin to enforce the law or that firms will themselves change their governance practices.

FIIs may be willing to wait for enforcement if they thought they could protect themselves through the kinds of protective measures we saw foreign investors adopt in the US as its stock markets grew (e.g., taking board seats, working through Investment Bankers in India). Although the use of these market oriented protections may be occurring (a matter I am investigating separately), it seems that the push for enacting Clause 49 indicates a need for enforcement such that these market protections may not have been perceived as sufficient by themselves.

FIIs might also be willing to wait if they thought the risk of theft and diversion was not high now, but might increase in a few years. For this reason to be credible we may need to make a few, quite plausible, assumptions. First, assume FIIs are keen to invest in India due to the high anticipated returns.

---

<sup>63</sup> It is possible that a law that is not immediately enforced could still lead to increases in share prices. If the stock markets capitalize future gains then even if the gains (from eventual enforcement) were at some distance in the future the market prices might increase somewhat. See Dharmapala & Khanna (2008).

<sup>64</sup> See Roe (1999).

Second, FIIs believe they can mostly ferret out truly fraudulent controllers and managers (i.e., those who start a company with the intent to defraud investors) with little help from the law. FIIs should be able to do this based on their experience, skills, and contacts in the local market.<sup>65</sup> Third, FIIs believe that, for the remaining non-fraudulent controllers and managers, theft and diversion is more likely when the firm has passed its high growth phase, not when it is in it. In other words, high growth firms present a smaller risk of expropriation than poorly performing firms. This also seems plausible based on the evidence we have on when firms are more likely to commit fraud (i.e., when they are performing poorly and when managers have fewer shares in the firms – both less likely for new high growth firms).<sup>66</sup> Fourth, FIIs believe that when the laws were announced that many firms in India were in or near the high growth phase. This also seems likely.

These assumptions provide an explanation for why FIIs might not have been concerned with immediate enforcement because they might think the chance of theft/diversion is not high then. However, the perception was that FIIs wanted the law enacted and enforced in the not-so-distant future. For that to be the case we must make an additional assumption: FIIs believed that in the medium term (e.g., 5 years or so) the more mature growth phase of most Indian firms would have arrived and the chance of theft and diversion would increase. This provides them with an incentive to want (or willingness to tolerate) a law enacted now and enforced in a few years. Again this seems quite plausible.

This is an explanation for why FIIs might be *willing* to wait for enforcement, but why would FIIs *believe* that a government would enact a law and then enforce it on a timetable that roughly suits the FIIs (or that firms would change their governance). This is especially intriguing in the context of an emerging market known to have concerns with enforcing the law.

One could imagine at least two stories. First, the government enacting a law could send a credible signal to FIIs about enforcement occurring in the medium to near term (the signaling account). Second, regardless of any signal sent by the government, FIIs may understand that due, in part to their investment, the stock markets in India will grow and attract more investors (especially domestic ones). The presence of these new investors will create a constituency that would lobby for enforcement once the mature growth phase comes (and the

---

<sup>65</sup> See Coffee (2001a).

<sup>66</sup> Most studies of corporate crime suggest that it is more likely to occur when managers are close to the last period for the firm and when they own less stock in the firm. See Alexander & Cohen (1994). This suggests that new high growth firms are less likely to engage in serious fraud.

chance of diversion increases) and that will likely result in enforcement (the constituency account).

Let us start with the signaling account. For a signal to be credible there must be some cost associated with sending the signal (or else anyone could send it).<sup>67</sup> What then is the cost to the government of sending this signal? Enacting a law generally occurs with a fair amount of effort (e.g., lobbying, drafting, debating) which may work to provide the cost for the signal. This seems plausible, but there are reasons to be skeptical in the Indian context.

First, the reforms were initiated by Industry which provided the government with a template (the CII Code) on which to build governance reforms. Thus, the government did not expend much effort on devising the rules. Second, the reforms were not enacted in an Act of Parliament (which requires substantial effort), but rather a SEBI rule which presumably requires less effort and provides less of a signal. Third, the penalties for non-compliance were weak and the implementation schedule fairly lengthy. None of these suggest that the government took a large political or other cost on itself in promulgating the Clause 49 reforms and thus can provide only a weak signal of a change in government attitude.<sup>68</sup>

However, if the government did not enforce the law in a reasonable time frame then it might lose credibility and this loss of credibility (i.e., reputation) may be the cost that makes the signal credible. This is plausible, but it is by no means clear that the Government of India (or for that matter governments in many emerging markets)<sup>69</sup> have that kind of reputation to put at stake.<sup>70</sup> Nonetheless, the general perception is that the Government of India has improved over time and perhaps that is sufficient to provide some loss of credibility if the government

---

<sup>67</sup> [Collecting cite]. If anyone can send a signal then one cannot not easily tell the difference between a real signal and a false one. See Akerlof (\_\_\_).

<sup>68</sup> Of course, it is plausible that a weak signal was all that was needed to attract return-hungry FIIs into the growing Indian economy. Indeed, this may explain some FII involvement, but there were FIIs who did not immediately enter the Indian market which suggests something more than weak signal was needed to attract them.

<sup>69</sup> There are measures of "good government" that might change over time, but it seems unlikely that the change in such measures for any given years would be much (e.g., the change from 2003 to 2004). I am in the process of inquiring into this for India.

<sup>70</sup> It is plausible that Indian companies (especially incumbents in an industry) may lobby for enforcement of the governance rules once they have ramped up their governance as a way to deter new entry into the industry. [Collecting Cites] This may well be so, but it is not immediately obvious why FIIs would use this as a basis to get excited about investing in India.

fails to enforce the law within a reasonable time frame. This may then be an important partial explanation.<sup>71</sup>

Let us then turn to the constituency account. Under that account the FIIs who start investing in India may expect that their increased demand for shares will push share prices up and once that happens other investors will be attracted to the Indian markets and something like a cascade or herd effect may begin to develop. As the number of smaller investors swells they would probably become large enough to form a constituency that lobbies for enforcement if the markets sour. This seems very plausible and indeed matches the experience FIIs have had in other markets.<sup>72</sup>

### c. Collective Action & FIIs

One can also sketch accounts that suggest the laws might benefit FIIs, even if not enforced, due to a species of collective action problems in the general population of investors. For example, FIIs may benefit from better governance because it might help increase the liquidity of the markets. Under this account FIIs benefit from the protection given to other (e.g., individual) investors because that will induce more such investors to enter the market which enhances liquidity. Moreover, laws that purport to protect smaller investors may help to develop a larger set of potential customers for FIIs in the future (for investing in India). If, for example, Fidelity were hoping to attract Indian investors to invest in a soon to be developed Fidelity Domestic India Fund then supporting enhanced governance in India would be a good strategy to curry favor with these investors. After all, smaller Indian investors would probably be reluctant to enter into the Indian stock markets without some assurances of protection.

Although this benefits FIIs, the question again becomes how does it benefit them if there is no enforcement? It might, depending on how much individual investors know. If individual investors are aware of the legal developments in India, but are not as aware, as FIIs, of the likelihood of enforcement then individual investors might be inclined to invest in the market thereby aiding

---

<sup>71</sup> Other parties may also try to use the law to signal things (firms, investors), but for a variety of related reasons these signals are unlikely to be any stronger than the government's signal just discussed. For example, Indian firms might attempt to signal that their firms are better governed now because of the presence of Clause 49. For this to be a credible signal a firm that falsely states that it has met Clause 49 must bear some greater cost than a firm that honestly states its position. However, at the time Clause 49 was adopted the cost of sending a false signal (i.e. stating the firm has good governance when the firm does not) would be small fines under the Companies Act of India 1956, which were unchanged by Clause 49.

<sup>72</sup> See Coffee (2001a); collecting cites.

liquidity. This may be another manifestation of the collective action problem facing smaller investors.

Although in theory plausible, one suspects this is not likely to eventuate in reality. This is because there would then be an opportunity for people to come into the market and short sell in order to profit off of this misperception of governance and enforcement.<sup>73</sup>

A similar situation arises when one considers the relationship between an FII's reputation and the law. An FII's reputation is implicated by its investment decisions and better governance may help to protect these reputations. When FIIs invest in a firm they put their reputation as an able investor on the line.<sup>74</sup> If the Indian firm turns out not to be a good investment then the FII's reputation will suffer and it may lose some of its own clients.

Although there is considerable evidence that FIIs serve as reputational intermediaries,<sup>75</sup> the question is how does the law relate to this? First, the law may serve as a partial substitute for reputation.<sup>76</sup> The law can do some monitoring that may substitute for the monitoring FIIs might otherwise do and thereby reduce the effort FIIs need to exert to monitor. If so, then FIIs may desire the law because it helps to reduce the amount of their reputational capital at stake when investing in firms. This is especially true for stocks in overseas markets where FIIs may be at an information disadvantage relative to local investors.<sup>77</sup> Second, the law may serve to complement monitoring by FIIs. An example might be when the law forces disclosure of information from firms in a standardized format to enable easier comparison, which reduces the costs of producing such easily comparable information for FIIs and serves to complement the monitoring by FIIs. Further, if the law serves as a complement then the FIIs would favor it because it enables their monitoring to occur at a cheaper cost.

---

<sup>73</sup> An advantage of the focus on liquidity is that it helps make some sense of a few other puzzles. For example, it appears that the reforms were targeted to attract FIIs, yet FIIs rarely seem to weigh governance too heavily and only occasionally intervene in governance. How might one square these two features? If governance reform only marginally protected FIIs as shareholders then they may not weigh it much in their individual firm investment decisions, but if it helped create a liquid market and enhance their customer base then FIIs would support the reforms.

<sup>74</sup> For example, if Fidelity invests in a firm then others in the market may view that firm as a good investment because Fidelity has a reputation for picking profitable firms and perhaps for monitoring.

<sup>75</sup> See Coffee (2001a).

<sup>76</sup> See Karpoff & Lott (1993).

<sup>77</sup> See Chan, et al (2005).



However, if the law is not enforced then the gains arising from complementarity would be weak because FIIs may not receive many standardized reports and may be unwilling to rely on them without expending further verification and processing costs. The gains from the substitution effects, however, could still be present. This depends on how much of the FII's reputation the market perceives is in play when the FII invests. The more protective the law is perceived to be the less an FII's reputation is put in play as less of their skill is needed. It is possible that smaller investors in the market (and some of the FII's clients) may be aware of legal developments in India, but are perhaps not as aware (as the FIIs) about the likelihood of enforcement. Given this asymmetry of information it is possible that smaller investors will place less of the FII's reputation at stake and this may benefit the FIIs.<sup>78</sup>

Again, although in theory plausible, one may have reason to be skeptical in India. First, it is questionable how much of an FII's reputation is saved by having the law as another potential target of blame. Second, if there was such a gap one might expect short sellers to enter the market and trade in ways to reduce the advantage.

**d. Information Provision - Comply or Explain?**

Even if Clause 49 was not enforced it did require disclosure of whether the firm was complying with Clause 49 and explanations if it was not.<sup>79</sup> If the firm disclosed that it was not complying that might have generated a negative response from the market.<sup>80</sup> To avoid this response some firms might attempt to enhance governance, keep quiet about their governance (which may send a negative signal to the market) or simply lie about their compliance with Clause 49. The latter strategy is problematic because although Clause 49 is not much enforced, the law relating to misleading disclosures can be (and is) enforced. Thus, lying about compliance with Clause 49 may generate penalties even though failing to comply with Clause 49 may not at the moment. If firms enhance their governance in response to a threatened loss of reputation or the penalty for lying then the FIIs may benefit.

However, for this account to work firms must anticipate a negative response to announcements that they are not complying with Clause 49 (without

---

<sup>78</sup> A similar argument can be made for large individual investors who may not want to put their reputational capital up for grabs by getting involved in foreign firms.

<sup>79</sup> See Clause 49, article \_\_\_\_.

<sup>80</sup> Cf. Arcot & Bruno (2007).

adequate explanations). Theoretically, it is not entirely clear why a firm's revelation of non-compliance would be very damaging when dealing with FII shareholders. First, if FIIs think certain aspects of governance are important for investment decisions they can demand that information from the firm. They can then assess whether the firm's governance practices are desirable deviations from Clause 49 (assuming, very plausibly, that Clause 49's requirements are not optimal for all firms). Thus, requiring disclosure under Clause 49 may be redundant if FIIs can demand it themselves. Of course, if we are dealing with passive small investors then we can imagine that the "compliance with Clause 49" disclosures are a useful heuristic, but for FIIs that seems less convincing.

Further, there are studies examining the impact of similar "comply or explain" governance rules in the UK, the Netherlands, Spain, Portugal, Japan, and in Germany. By and large these studies find that compliance with such codes does not correlate with firm performance or stock price performance.<sup>81</sup> Most recently, Arcot & Bruno (2007) examine the rules in the UK and find that compliance with the rules does not necessarily correlate with better performance, but non-compliance accompanied by a sensible explanation for non-compliance does correlate with better performance. Nowak, Rott & Mahr (2006) find that announcements by German firms that they complied (or did not comply) with the German Code had little short run or long run impact on stock price performance. To my knowledge no such study exists on Indian governance reforms, although one is in process.<sup>82</sup> Nonetheless, given the studies in other countries one is not optimistic about finding much.

## **B. Expressive & Norm Change Accounts**

---

<sup>81</sup> Weir, Laing & McKinght (2000) find only a weak relationship between compliance with the UK code and firm performance. De Jong, DeJong, Mertens & Wasley (2004) examine the self-regulatory code in the Netherlands and find little effect on firm value. Alves & Mendes (2004) find little effect in Portugal. Gilson & Milhaupt (2005) find little effect in response to the Japanese code. Fernandez-Rodriguez, Gomez-Anson & Cuervo-Garcia (2004) find only positive responses to announcements of compliance with the Spanish code if other governance changes are implemented (e.g., major restructuring of the board). There are occasional studies finding a positive effect. Padgett & Shabbir (2005) find that compliance with the UK code is associated with higher total shareholder return (sum of capital gain and dividend yield). Zimmermann, Goncharov & Werner (2004) examine whether compliance with the German Corporate Governance Code has an impact on stock valuation and find that, once they control for endogeneity, that there was a valuation impact of compliance with the code.

<sup>82</sup> See Vikramaditya Khanna, *Does it Matter to Firm Value if Firms Comply or Explain their Non-Compliance with Indian Governance Rules?*, (2008) Draft. However, one should note that the CII code was a voluntary code and the general perception was that this was not sufficient to induce FII interest – which in essence created the need to lobby for a law. This suggests that the results in India from "comply or explain" rules are unlikely to be very positive.

Finally, another method in which law could have an impact sans enforcement is through its expressive and norm changing effects. One expressive argument is that Clause 49 could serve to inform market players (firms and domestic investors) what better governance standards were and then the players could adopt these standards themselves.<sup>83</sup> In essence, the law serves as an information provider or coordinator on good governance standards. In India this has little applicability because Clause 49 was largely a copy of Industry standards for governance. Thus, firms and investors probably knew what the better governance standards were already due in large part to the CII Code. The law may have served an ancillary function to advertise these rules more broadly than the Industry standards, but even then the additional audience this reached is likely to have been quite small.<sup>84</sup>

Another related account may be that the law signaled a change in governance norms that had occurred, or were occurring, in India. In other words, the lobbying effort needed to enact Clause 49 signaled that firms in India had changed, or were changing, their governance practices. This signal may have been viewed favorably by FIIs because it suggests firms were now beginning to comply with higher governance standards. Thus, the mere presence of Clause 49 resulting from Industry lobbying is the signal. Although this seems plausible, given that the reforms were proposed by Industry, the significant non-compliance with Clause 49 raises concerns about this account.<sup>85</sup> Nonetheless, one cannot completely discount it because whether 50% of firms complying with new rules is good or bad depends on where one started. If only 20% of firms were complying with better governance standards in 2000 then 50% compliance in 2007 is actually quite good. I am in the process of gathering evidence on compliance rates from 1999-2007, but little more can be said at this stage. Thus, this may have some explanatory force.

An alternative expressive account is that norms may not yet have changed, but Clause 49 set out aspirational (or perhaps inspirational) governance standards

---

<sup>83</sup> See McAdams (2000), (2007).

<sup>84</sup> This is not a pure focal point argument as it does matter which governance standard firms coalesce around – we are not coordinating around whether a red or green light indicates stop.

<sup>85</sup> See R. Bijith, *Half of BSE listed Cos Yet to Comply with Clause 49*, THE INDIAN EXPRESS, January 3, 2007. One countervailing consideration is that Indian firms appeared to spend a considerable amount of time and effort in finding independent directors to meet the requirements of Clause 49 (at least they claimed they did).

Finally, the lackluster enforcement stands in contrast to other markets which have added credibility to their attempts to move to different standards of behavior by having very visible and prompt enforcement actions and regulatory measures (e.g., criminal sanctions in Korea; Sarbanes-Oxley and the Federal Securities Laws in the US - see Milhaupt & Pistor, 2008).

for Indian firms that might lead to changes. This may well be true in some measure, but it is unclear why a new regulation, as opposed to a new law, was likely to do this. One could imagine that the enactment of a new law – which requires going through multiple levels of scrutiny and legislative debate in a democracy – might send a strong signal about what is valued by the polity (Milhaupt & Pistor, 2008). However, a change in a listing rule does not require the same level of effort or commitment by the polity and hence would not send as powerful a message as a new law. Indeed, it is dubious how much power one can get out of a regulatory change in an environment where the regulator, although well-respected, does not yet have the pedigree of something like the US Securities & Exchange Commission or the imprimatur of a new law enacted by democratically elected representatives. The point is that the change in attitude signaled by a newly enacted law is much greater than that signaled by a rule change enacted by a relatively new regulator.<sup>86</sup>

Further, changing norms through legal enactments is not always easy and rarely happens quickly. Moreover, there is reason to believe that norm change tends to take longer in more heterogeneous settings (Coffee, 2001b) and India is indeed one of the more heterogeneous countries. In light of this, it seems a bit optimistic to view the increases in the Indian markets as being driven by a perception that governance norms would change quickly in India following the enactment of a law that was not enforced for over 7 years.

The analysis in this part suggests that FII interest in India may have increased for a number of reasons upon the enactment of Clause 49 and increasing sanctions for its violation. These may have sent a signal about the government's attitude to corporate governance reform as well as suggesting some change in governance practices in Indian firms given Industry support for the reforms. Nonetheless, for any of these explanations to have traction we also need an explanation for why FIIs would have been willing to wait for enforcement for a few years. I suggest that FIIs may have thought that the risk for insider diversion and theft was low at the time, but might increase in a few years. As long as enforcement seemed more likely by the time the risk of diversion increased that might have been sufficient to move some FIIs at the margin.

This suggests that enforcement is important, but that initially active civil enforcement was not critical in India. This raises a host of questions that I can

---

<sup>86</sup> The argument in this paragraph is that the law might be used to change preferences not that it reflects changes in preference – the argument addressed in the earlier paragraph.

only highlight in this paper. For example, is this analysis in India generalizable to other emerging markets? It may not be given that the Indian experience is unusual in that governance reform came about from the “bottom up” (i.e., via Industry support) as opposed to “top down” (e.g., as the result of responding to scandals). In this respect the Indian experience is closer to the US and the UK where private players were critical in stock market development. Other emerging markets may not necessarily be in the same position.

However, the experience in India may be generalizable to the extent it reflects FII experience in other countries and to the extent that the step-by-step almost gradualist approach in India may be useful for other countries to consider. This is especially valuable as one considers making reforms politically supportable in an emerging market.

Another related question is how critical is immediate enforcement if Industry is supporting the reforms? In an environment where Industry is supportive of reform one may need less immediate enforcement when compared to an environment where Industry is opposed to the reforms to convince FIIs that the reforms likely reflect changes in governance.

Yet another question to explore is whether examining civil enforcement of corporate and securities laws in emerging markets is really going to generate much movement compared to other types of enforcement – say criminal enforcement? This is an important question as one begins to examine what steps can other emerging markets take to enhance stock market development, both when Industry is supportive of the reforms and especially when it is not.

Although one cannot answer all these questions here, analyzing the experience in India provides a useful springboard to engage in these questions. I leave greater discussion for future research.

## V. CONCLUSION

Recent corporate governance research is turning to examine which aspects of corporate governance matter most to growth. Although scholarly attention is now focused on enforcement, there is little examination of how the reforms and enforcement may matter in an *emerging market*. Such an examination is important because emerging markets usually have weaker enforcement, but many of them appear to benefit from governance reform. This paper pursues this by exploring these questions in a large emerging market – India.

My analysis suggests that although India's substantive corporate law reforms were received positively by the stock markets, there was virtually no enforcement of these reforms for a number of years. This raises a puzzle: why did the Indian law reforms appear to be associated with substantial growth in the Indian markets when enforcement of those laws was very weak?

To answer this question we need to focus on the important drivers of Indian stock market growth at that time – foreign institutional investors (FIIs). Why did the FIIs increase their presence and interest in the Indian stock markets when reforms were enacted, but not immediately enforced?

I examine a number of accounts and find some to be potentially important (e.g., reforms signaling changes in government attitudes and/or firms likely governance behaviors). Nonetheless, we still need an account of why FIIs thought that even delayed enforcement of the new laws was sufficient to make investment in India more attractive at the margin. I argue that given the high returns available in India, FIIs may have thought that the need for enforcement was not pressing now (as the chance of insider diversion may not be high at that time), but could become so in the next few years when the market eventually cooled down. Thus, enacting the law now was attractive because then it would be available once the chance of diversion increased. Once FIIs started coming to India other investors also increased their investments in Indian firms. As the number of investors swelled, this fueled the growth of the Indian markets, while simultaneously creating the constituency that would seek active enforcement when a downturn eventually comes and the chances of diversion increase.<sup>87</sup>

This analysis suggests that enforcement is important to the growth of stock markets, but active civil enforcement of corporate laws may not always be critical to their *initial* development. Of course, continued weak enforcement is likely to undermine a stock market, but early on strong civil enforcement of corporate law may not always be essential. Indeed, this has been the experience of many countries when their stock markets were developing. If we examine the US and the UK the key features leading to the growth of their financial markets were growth in the economy, need for external capital, and rules, norms and understandings that protect or will attract larger investors to the market (Coffee,

---

<sup>87</sup> One might conjecture that most law reforms arise in response to scandals so enforcement is essential to secure confidence in the market, but in India the reforms came not from scandal but from Industry where the urgency of enforcement may not have been as necessary to induce investment.

2001a; Rajan & Zingales, 2003). Once larger investors enter a fast growing market one tends to see share price increases that are likely to attract smaller investors to the market and the cascade develops.<sup>88</sup> In India, something similar has happened although the assurances to potential investors were provided more by Industry and government together.

This leads to a number of further questions which I can only begin to explore in this paper. For example, how much can we generalize from the Indian experience to other emerging markets? Might the unique role of Indian Industry support for governance reforms influence how important enforcement is? Might criminal enforcement be more critical to stock market development than civil enforcement of corporate law? Answers to these questions help to flesh out the importance of enforcement and how it interacts with the background context of the law reforms.

## REFERENCES

- Acemoglu, Darren & Simon Johnson (2006), "Unbundling Institutions", Working Paper.
- Aggarwal, Reena, Leora Klapper, and Peter D. Wysocki (2003), "Portfolio Preferences of Foreign Institutional Investors," World Bank Working Paper.
- Alexander, Cindy & Mark Cohen (1994), "\_\_\_\_", \_\_\_\_\_.
- Alves, Carlos and Victor Mendes (2004), "Corporate Governance Policy and Company Performance: The Portuguese Case", 12 *Corporate Governance: An International Review* 290 – 301.
- Akerlof, George \_\_\_\_\_.
- Ammer, John, Sara B. Holland, David C. Smith and Francis E Warnock (2006), "Look at Me Now: What Attracts U.S. Shareholders?", Working Paper, at <http://ssrn.com/abstract=556208>.
- Anant, T.C.A. and Omkar Goswami (1995) *Getting Everything Wrong: India's Policies Regarding 'Sick' Firms*, in Dilip Mookherjee (ed.), *INDIAN INDUSTRY: POLICIES AND PERFORMANCE*.
- Arcot, Sridhar R. and Valentina Giulia Bruno (2007), "One Size Does Not Fit All, After All: Evidence from Corporate Governance," Working Paper, at <http://ssrn.com/abstract=887947>.
- Atanasov, Vladimir, Bernard Black, Conrad Ciccotello and Stanley Gyoshev (2007), "How Does Law Affect Finance: An Examination of Financial Tunneling in an Emerging Market", Working Paper, at <http://ssrn.com/abstract=902766>.
- Balasubramanian, N., Bernard S. Black and Vikramaditya Khanna (2008), "Firm-level Corporate Governance in Emerging Markets: A Case Study of India, working

---

<sup>88</sup> See Bickchandani, Hirshleifer & Welch (1992). Cascades can be notoriously fragile, which could be reduced or addressed by law changes to some extent.

paper.

- Bebchuk, Lucian Arye, Cohen, Alma and Ferrell, Allen, "What Matters in Corporate Governance?" (September 2004). Harvard Law School John M. Olin Center Discussion Paper No. 491, at <http://ssrn.com/abstract=593423>.
- Beny, Laura A. and Anita I. Anand (2007), "Private Regulation of Insider Trading in the Shadow of Lax Public Enforcement (and a Strong Neighbor): Evidence from Canadian Firms", Working paper, at <http://ssrn.com/abstract=1013482>.
- Bertrand, M., P. Mehta and S. Mullainathan (2002) "Ferretting out Tunneling: An Application to Indian Business Groups" QUARTERLY JOURNAL OF ECONOMICS, 121-148.
- Bhattacharyya, Asish K and Sadhalaxmi Vivek Rao (2005), "Economic Impact of 'Regulation on Corporate Governance': Evidence from India", Working Paper, at <http://ssrn.com/abstract=640842>.
- Bhattacharya, Utpal and H. Daouk (2006), "The World Price of Insider Trading", 57 JOURNAL OF FINANCE 75-108.
- Bikhchandani, Sushil, D. Hirshleifer and I. Welch, "A Theory of Fads, Fashion, Custom and Cultural Change as Informational Cascades", 100 JOURNAL OF POLITICAL ECONOMY 992 (1992).
- Bikhchandani, Sushil, D. Hirshleifer and I. Welch, "Learning from the Behavior of Others: Conformity, Fads and Informational Cascades", 12 JOURNAL OF ECONOMIC PERSPECTIVES 151 (1998).
- Black, Bernard, Hasung Jang and Woonchan Kim (2006), "Does Corporate Governance Affect Firms' Market Values? Evidence from Korea" JOURNAL OF LAW, ECONOMICS AND ORGANIZATION, Vol. 22, 366-413.
- Black, Bernard S. and Vikramaditya Khanna (2007), "Can Corporate Governance Reforms Increase Firms' Market Values? Evidence from India", 4 JOURNAL OF EMPIRICAL LEGAL STUDIES 749 – 795.
- Chakrabarti, Rajesh (2006), "Corporate Governance in India – Evolution and Challenges," in THE FINANCIAL SECTOR IN INDIA -- EMERGING ISSUES (Oxford University Press, New Delhi), pp. 196-219.
- Chari, Anusha and Nandini Gupta (2007), "Incumbents and Protectionism: The Political Economy of Foreign Entry Liberalization", Forthcoming *Journal of Financial Economics*.
- Coffee, John C. Jr. (2001a), "The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control", 111 YALE L. J. 1.
- Coffee, John C. Jr. (2001b), "Do Norms Matter? A Cross-Country Evaluation", 149 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 2151-2177.
- Coffee, John C. Jr. (2002), "Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance," 102 COLUMBIA LAW REVIEW, 1757 – 1831.
- Coffee, John C., Jr. (2007), "Law and the Market: The Impact of Enforcement", working paper, at [http://papers.ssrn.com/paper.taf?abstract\\_id=967482](http://papers.ssrn.com/paper.taf?abstract_id=967482).



- CONFEDERATION OF INDIAN INDUSTRY, DESIRABLE CORPORATE GOVERNANCE: A CODE (1998).
- Cremers, K. J. Martijn and Vinay B. Nair (2005), "Governance Mechanisms and Equity Prices", 60 *JOURNAL OF FINANCE* 2859 -2894.
- Daines, Robert and Charles Jones (2007), "Mandatory Disclosure, Information Asymmetry and Liquidity: The Effect of the 1934 Act", Working Paper, at [http://www.law.yale.edu/documents/pdf/CBL/34\\_Yale.pdf](http://www.law.yale.edu/documents/pdf/CBL/34_Yale.pdf).
- De Jong A., D. DeJong, G. Mertens and C. Wasley (2005) The Role of Self-Regulation in Corporate Governance: Evidence and Implications from The Netherlands, 11 *Journal of Corporate Finance* 473-503
- Dharmapala, Dhammika and Vikramaditya Khanna (2008), "Corporate Governance, Enforcement, and Firm Value: Evidence from India", working paper.
- Douma, Sytte, Reje George and Rezaul Kabir (2006), "Foreign and Domestic Ownership, Business Groups, and Firm Performance: Evidence from a Large Emerging Market", 27 *Strategic Management Journal* 637-657.
- Durnev, A., and E. H. Kim (2005) "To Steal or Not to Steal: Firm Attributes, Legal Environment, and Valuation" *Journal of Finance*, 60, 1461-1493.
- Fernandez-Rodriguez, Enrique, Silvia Gomez-Anson and Alvaro Cuervo-Garcia (2004) The Stock Market Reaction to the Introduction of Best Practice Codes by Spanish Firms, 12 *Corporate Governance: An International Review* 29-46.
- Ferreira, Miguel A., and Pedro Matos (2007), "The Colors of Investors' Money: The Role of Institutional Investors Around the World," *Journal of Financial Economics*, forthcoming, at <http://ssrn.com/abstract=885777>.
- Gillan, Stuart L., Jay C. Hartzell and Laura T. Starks (2003), "Industries, Investment Opportunities, and Corporate Governance Structures", working paper.
- Gilson, Ronald J. and Milhaupt, Curtis J., (2004) "Choice as Regulatory Reform: The Case of Japanese Corporate Governance", working paper, at <http://ssrn.com/abstract=537843>
- Gompers, P. A., J. Ishii and A. Metrick (2003) "Corporate Governance and Equity Prices" *Quarterly Journal of Economics*, 118, 107-155.
- Goswami, Omkar (2003) "India: The Tide Rises Gradually" in Corporate Governance in Development (Charles P. Oman ed., OECD Development Centre), pp. 105–60.
- Irani, Jamshed J., (2005), REPORT OF THE EXPERT COMMITTEE TO ADVISE THE GOVERNMENT ON THE NEW COMPANY LAW.
- Jackson, Howell E. and Mark J. Roe, "Public Enforcement of Securities Laws: Preliminary Evidence", working paper, at <http://ssrn.com/abstract=1000086>.
- Khanna, Tarun., and Krishna. G. Palepu (1999) "Policy Shocks, Market Intermediaries, and Corporate Strategy: Evidence from Chile and India" *Journal of Economics and Management Strategy*, vol. 8, pp. 271-310.
- Khanna, Tarun, Krishna G. Palepu, and Suraj Srinivasan (2004), "Disclosure Practices of Foreign Companies Interacting With U.S. Markets", 42 *Journal of Accounting Research* 475-508.
- Khanna, Tarun, Joe Kogan, and Krishna G. Palepu (2006), "Globalization and Similarities

- in Corporate Governance: A Cross-country Analysis", 88 *Review of Economics and Statistics* 69-90.
- Khanna, Tarun and Krishna Palepu (2007), "The Evolution of Concentrated Ownership in India: Broad Patterns and a History of the Indian Software Industry," in Randall K. Morck, ed., *A History of Corporate Governance Around the World* (National Bureau of Economic Research), pp. 283-324.
- Khanna, V.S. (1996), "Corporate Criminal Liability: What Purpose Does It Serve?", 109 *HARV. L. REV.* 1477.
- Khanna, Vikramaditya (2008), *Does it Matter to Firm Value if Firms Comply or Explain their Non-Compliance with Indian Governance Rules?*, working paper.
- La Porta, Rafael, Florencio Lopez-de-Silanes and Andrei Shleifer (2006), "What Works in Securities Laws?", *JOURNAL OF FINANCE* 61, 1-32.
- La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (1998), "Law and Finance", *JOURNAL OF POLITICAL ECONOMY* 106, 1113-1155.
- La Porta, Rafael, Florencio Lopez-De-Silanes, Andrei Shleifer, and Robert W. Vishny (1997), *Legal Determinants of External Finance*, 52 *JOURNAL OF FINANCE* 1131 – 1150.
- Liebman, Benjamin L. and Curtis J. Milhaupt, (2007), "Reputational Sanctions in China's Securities Market", Columbia Law and Economics Working Paper No. 318, at <http://ssrn.com/abstract=999698>.
- McAdams, Richard H. (2000), "A Focal Point Theory of Expressive Law", 86 *Virginia Law Review* 1649-1729.
- McAdams, Richard H. and Janice Nadler (2007), "Coordinating in the Shadow of the Law: Two Contextualized Tests of the Focal Point Theory of Legal Compliance", working paper, at [http://ssrn.com/abstract\\_id=1016488](http://ssrn.com/abstract_id=1016488).
- Milhaupt, Curtis J. and Pistor, Katharina (2008), "Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World", University of Chicago Press, working paper, at <http://ssrn.com/abstract=987291>
- Morris, M. D. (1983)., "The Growth of Large Scale Industry up to 1947", in D. KUMAR (ED.) *CAMBRIDGE ECONOMIC HISTORY OF INDIA VOL. 2* 553 – 676.
- Nenova, Tatiana (2005), "Control Values and Changes in Corporate Law in Brazil", *Latin American Business Review*, Vol. 6, 1-37.
- Nowak, Eric, Roland Rott and Till G. Mahr, "The (Ir)relevance of Disclosure of Compliance with Corporate Governance Codes – Evidence from the German Stock Market", Research Paper Series N°06 – 11, at \_\_\_\_.
- Padgett, Carol & Amama Shabbir (2005), "Does Compliance with the German Corporate Governance Code have an Impact on Stock Valuation? An Empirical Analysis", Working Paper, University of Bremen.
- Polinsky, A. Mitchell and Steven M. Shavell (2000), "The Economic Theory of Public Enforcement of Law", *Journal of Economic Literature* 38, 45-76.
- Rajan, Raghuram and Luigi Zingales (1998), "Financial Dependence and Growth," 88 *American Economic Review* 559-586.
- Rajan, Raghuram and Luigi Zingales (2003), "The Great Reversals: the Politics of

- Financial Development in the Twentieth Century", 69 *Journal of Financial Economics* 5-50.
- REPORT OF THE COMMITTEE APPOINTED BY THE SEBI ON CORPORATE GOVERNANCE UNDER THE CHAIRMANSHIP OF SHRI KUMAR MANGALAM BIRLA (1999).
- Roe, Mark J. (1999), "Backlash", \_\_\_ COLUM. L. REV. \_\_\_.
- Roe, Mark J. (2006), "Legal Origins, Politics and Modern Stock Markets", 120 HARVARD LAW REVIEW 460 – 526.
- Sarkar, Subrata and Jayati Sarkar (2000) "Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India," *International Review of Finance*, vol. 1, 161-194.
- Spamann, Holger (2006), "On the Insignificance and/or Endogeneity of La Porta et al.'s 'Anti-director rights index' under consistent coding", Harvard Law School John M. Olin Center Discussion Paper No. 7, (at <http://ssrn.com/abstract=894301>).
- Weir, Charlie, David Laing & Phillip J. McKnight (2000), Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies, 29 *Journal of Business and Accounting* 579-611.
- World Bank Report (2005), *India: Role of Institutional Investors in the Corporate Governance of their Portfolio Companies*.
- Zimmermann, Jochen, Igor Goncharov and Joerg-Richard Werner (2004), "Does Compliance with the German Corporate Governance Code have an Impact on Stock Valuation? An Empirical Analysis", Working Paper, University of Bremen.

**Appendix 1**  
**Comparing Clause 49 and the JJ Irani Committee Recommendations**

Characteristic	Clause 49	JJ Irani Committee
<b>Independence</b>	<ul style="list-style-type: none"> <li>• <u>Requirement</u> – 50% independent directors if Chairman is executive director or 33% if Chairman is not.</li> <li>• <u>Definition</u> - not related to Board or one level below Board and audit partners must have no prior relationship with the Company for the last 3 years.</li> <li>• <u>“Material”</u> - There is no requirement for the relationship to be “material”.</li> <li>• <u>Financial institutions</u> - are considered independent.</li> </ul>	<ul style="list-style-type: none"> <li>• <u>Requirement</u> – 33% for companies with public interest.</li> <li>• <u>Definition</u> - not related to employees of the Company and no prior relationship with the Company for one year.</li> <li>• <u>“Material”</u> - board to review on an on-going basis.</li> <li>• <u>Financial institutions</u> - not considered independent.</li> </ul>
<b>Board Requirements &amp; Limitations</b>	<ul style="list-style-type: none"> <li>• Meet 4 times a year (maximum gap of 3 months between meetings)</li> <li>• Limits on number of committees a director can be on (10), but only 5 for which director can be Chair of committee.</li> <li>• Develop Code of Conduct.</li> </ul>	<ul style="list-style-type: none"> <li>• Meet 4 times a year (maximum gap of 4 months between meetings).</li> <li>• Limits of number of directorships (15).</li> </ul>
<b>Audit Committee Composition</b>	<ul style="list-style-type: none"> <li>• At least 3 directors (two-thirds must be independent).</li> <li>• All financial literate.</li> <li>• At least one having accounting or financial management experience.</li> </ul>	<ul style="list-style-type: none"> <li>• No minimum number of directors (majority need to be independent).</li> <li>• No requirements for financial literacy.</li> <li>• At least one should have accounting/financial management knowledge.</li> </ul>
<b>Audit Committee Role &amp; Powers</b>	<ul style="list-style-type: none"> <li>• Audit Committee Meetings – 4 meetings (gap between meetings not exceed 4 months).</li> <li>• Audit Committee role is broad – review statutory and internal auditors as well as internal audit function.</li> </ul>	<ul style="list-style-type: none"> <li>• Audit Committee Meetings – number not specified.</li> </ul>

<b>Disclosures</b>	<ul style="list-style-type: none"> <li>• Related party transactions,</li> <li>• Accounting treatments and departures,</li> <li>• Risk management,</li> <li>• Proceeds from offerings,</li> <li>• Compensation for directors (including non-executives and obtain shareholders' approval),</li> <li>• Details of compliance history for last 3 years.</li> <li>• Corporate governance reports (and disclose adoption, if any, of mandatory and non-mandatory requirements).</li> </ul>	<ul style="list-style-type: none"> <li>• Related party transactions,</li> <li>• Executive compensation,</li> <li>• Unusual transactions,</li> <li>• Director's background.</li> </ul>
<b>Certifications</b>	<ul style="list-style-type: none"> <li>• <u>CEO &amp; CFO:</u> <ul style="list-style-type: none"> <li>▪ financial statements</li> <li>▪ effectiveness of internal controls</li> <li>▪ legal transactions</li> <li>▪ inform audit committee of any significant changes in the above.</li> </ul> </li> <li>• <u>Auditor or Company Secretary:</u> <ul style="list-style-type: none"> <li>▪ Compliance with corporate governance</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• <u>CEO, CFO &amp; Company Secretary</u> <ul style="list-style-type: none"> <li>▪ financials</li> </ul> </li> <li>• <u>CEO and CFO:</u> <ul style="list-style-type: none"> <li>▪ internal controls (with audit committee approval).</li> </ul> </li> </ul>
<b>Subsidiary Companies</b>	<ul style="list-style-type: none"> <li>• At least one Independent director of Holding Company should sit as a director on Board of material non-listed Indian subsidiary.</li> <li>• Significant transactions report to Holding company Board (along with subsidiary board's minutes).</li> </ul>	
<b>Other</b>	<ul style="list-style-type: none"> <li>• Whistleblower policy is optional</li> <li>• Independent directors loses status as "independent" if served 9 years at company</li> <li>• Training board members</li> <li>• Evaluate non-executive board performance.</li> </ul>	<ul style="list-style-type: none"> <li>• Whistleblower policy and protection for whistleblower is encouraged.</li> </ul>