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RESTRUCTURING PROFESSIONAL FIRMS FOR GATS REGIME

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INTRODUCTION

Services have come to dominate the economic activities of countries at virtually every stage of development, making liberalisation of trade in services a necessity for the integration of the world economy. In many developing economies as well, the service sector is the single largest contributor to economic output, ahead of both agriculture and industry. Even allowing for the fact that governments are major service providers (education, healthcare, sanitation, etc.), the commercial market for services is huge and growing in virtually every country. And the trend is clear: as national economies develop and incomes rise, the commercial service sector accounts for an ever-larger share of GDP.

Services today accounting for 20% of global trade and 5% of global GDP, are a high employment generating sector and employ as high as 40% and 70% of the workforce in developing and developed countries, respectively. Although large OECD countries dominate global trade in services, developing countries top the list of countries that are most specialized in services exports as a source of foreign exchange. Many developing countries like India and Philippines have become major exporters of BPO services and emerged as an important destination for investment in services like insurance, transport, telecommunication and retail trading by the developed countries.

In line with the global trend, the services sector in India is also growing rapidly as is evident from its share in GDP. In 2000-2001, the share of services in the country's GDP at 52.4% was up from 51.5% in the year 1998-1999. More importantly the services sector in India account for about a quarter of India's trade flows during the same period. High growth of service exports demonstrate higher share of India in global trade for service i.e., 1.4% compared to 0.9% in case of global merchandise trade. The service sector has also played an important role in attracting foreign capital, with key

producer services amounting for a growing share of foreign direct investment (FDI) inflows into the country thus exhibiting a strong revealed comparative advantage in services vis-à-vis goods.

The year 2004-2005 was especially very encouraging in terms of growth of export in services doubling to \$51.3 billion from \$24.9 billion in 2003-04 an astounding growth of 105.7%. There was substantial growth in value added services in communication, construction, financial, news agency, royalty, copyright, licence fee and management. Exports of these services categorized as "miscellaneous services" (excluding software) are believed to have increased more than four-fold to \$22.5 billion in 2004-05 from \$4.7 billion in 2003-2004. Though the miscellaneous services category registered highest growth, software exports went up by 41.8% to \$ 17.3 billion in 2004-2005, the highest increase in the last four years. A report by NASSCOM and Mckinsey pointed out that the exports of IT related services from India are expected to increase to US\$57 billion by 2008-2009. Another study by Deloitte reveals that the global market for off-shore financial services could be as large as US\$356 billion by 2008-2009, of which a large share should go to India.

India's main source of comparative advantage in services is its labour endowment. India is also an important source country for low and semi-skilled service providers in services like construction, domestic work, and transport operations. It also has the potential to export labour-intensive services though technology-enabled data, voice, and information flows, i.e. cross-border supply.

India is also ranked as the leading global outsourcing destination in services. In all, 60% of the Fortune 500 companies outsourcing services to India, ranging from simple back office services like processing and billing, to intermediate service like technical help and systems design to specialized services, like research and

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development and technical analysis. The cost-quality advantage in labour-based services combined with its high quality institutions has also enabled the country to considerably diversify its services exports to emerging areas, like health care, research & development and educational services. Thus, the range of activities, modes, and markets where India has global export opportunities is vast.

Undoubtedly, the growing volume and scope of exportable services and the possibility of growing protectionism towards outsourcing calls for a determined and innovative GATS negotiation and export promotion strategy. The need to identify newer export sectors in services trade based on the comparative advantage and professional competence available in India assumes greater importance given the international opportunities.

PROFESSIONAL SERVICES UNDER GATS REGIME

Professional services have a wide range of activities even though many of them have certain common characteristics. Professional services primarily purchased by the others are mostly delivering expertise calling for inputs from skilled professional, technical and managerial personnel and comprises a mix of activities, such as accountants, legal and secretarial services, auditing etc. which require some type of accrediting. However, large firms have considerable advantage in providing a package of professional services. Many specialized firms in specific sectors may also prove to be very competitive in view of the fact that they are able to access the delivery channel as comfortably as the large firms do.

In the case of professional services, despite the considerably varied nature of the services making up this category, there are several important commonalities. Firstly, India has considerable export potential in many of these activities due to its skilled, low-cost labour resources and demand-supply imbalances in many developed countries resulting from demographic trends and rapid advances in technology. In some professional services, India has considerable export potential; exports are constrained by a variety of restrictions, including lack of recognitions of Indian qualifications, nationality and residency conditions, needs-based tests and commercial presence requirements in host markets. In addition to relying on its endowment of skilled labour, India also has the potential for cross-border exports of various IT-enabled professional services, such as back-office activities which include processing, billing, handling calls, medical and legal transcription, tele medicine, tele-education and a variety of on-line and outsourced services.

STRUCTURE OF GATS REGIME

The creation of the GATS was one of the landmark achievements of the Uruguay Round, whose results entered into force in January 1995. The GATS for the first time extended internationally agreed rules and commitments into the rapidly growing area of international trade viz. services, which was never done before. The preamble of GATS expresses desire to facilitate the increasing participation of developing countries in trade in services and the expansion of services exports through the strengthening of their domestic capacity, efficiency and competitiveness.

GATS framework consists of six parts and annexes. The GATS is based on the same objectives as that of GATT of creating a credible and reliable system of international trade rules; ensuring fair and equitable treatment of all participants (principle of non-discrimination); stimulating economic activity through guaranteed policy bindings; and promoting trade and development through progressive liberalisation. Further negotiations for progressive liberalisation commenced by 1.1.2000, as mandated under GATS and the forthcoming negotiations on services are scheduled in the month of December 2005 at Hong Kong.

The GATS applies in principle to all service sectors except "services supplied in the exercise of governmental authority". These are services that are supplied neither on a commercial basis nor in competition with other suppliers viz. social security schemes and central banking.

MODES OF SUPPLY OF SERVICES UNDER GATS

The GATS sets out four modes of supply of services. These include cross border trade, consumption abroad, commercial presence and movement of natural persons.

GENERAL PRINCIPLES

Following are the basic rules/principles applicable to all members and to all services.

MFN Treatment

Article II of the GATS provides that each Member shall accord, immediately and unconditionally, to services and service suppliers of any other Member, treatment no less favourable than it accords to like services and service suppliers of any other country. However, a member is permitted to maintain a measure inconsistent with the general MFN requirement if it has established an exception. However, all exemptions are subject to

review and they should, in principle, not last more than 10 years.

Transparency

The GATS requires each member to publish promptly "all relevant measures of general application" that affect operation of the agreement. Members must also notify the Council for Trade in Services of new or changed laws, regulations or administrative guidelines that affect trade in services covered by their specific commitments under the agreement. Each member is required to establish an enquiry point, to respond to requests from other members for information.

Specific Obligations

Obligations, which apply on the basis of commitments, are laid down in individual country schedules concerning market access and national treatment in specifically designated sectors. These requirements apply only to scheduled sectors.

Market Access

Market access is a negotiated commitment in specified sectors. The GATS also sets out different forms of measures affecting free market access that should not be applied to the foreign service or its supplier unless their use is clearly provided for in the schedule. They are:

- (i) Limitations on the number of service suppliers.
- (ii) Limitations on the total value of services transactions or assets.
- (iii) Limitations on the total number of service operations or the total quantity of service output.
- (iv) Limitations on the number of persons that may be employed in a particular sector or by a particular supplier
- (v) Measures that restrict or require supply of the service through specific types of legal entity or joint venture.
- (v) Percentage limitations on the participation of foreign capital, or limitations on the total value of foreign investment.

National Treatment

A commitment to national treatment means that in the sectors covered by its schedule, subjected to any conditions and qualifications set out therein each member shall give treatment to foreign services and service suppliers treatment, in measures affecting supply of services, no less favourable than it gives to its own

services and suppliers. The extension of national treatment in any particular sector may be made subject to conditions and qualifications.

Members are free to tailor the sector coverage and substantive content of such commitments as they deem fit. The commitments thus tend to reflect national policy objectives and constraints, overall and in individual sectors. While some Members have scheduled less than a handful of services, others have assumed market access and national treatment disciplines in over 120 out of a total of 160-odd services.

Exemptions

Members in specified circumstances are allowed to introduce or maintain measures in contravention of their obligations under the Agreement, including the MFN requirement or specific commitments. These circumstances cover measures necessary to protect public morals or maintain public order, protect human, animal or plant life or health or secure compliance with laws or regulations not inconsistent with the Agreement including, among others, measures necessary to prevent deceptive or fraudulent practices. Also, in the event of serious balance-of-payments difficulties, members are allowed to temporarily restrict trade, on a non-discriminatory basis, despite the existence of specific commitments.

CLASSIFICATION OF PROFESSIONAL SERVICES UNDER GATS

The WTO Secretariat has divided all services into twelve categories, covering business services, communication services, construction and engineering services, distribution services, education services, environment services, financial services, health services, tourism and travel services, recreation, cultural and sporting services, transportation services and other services.

The professional services covered under Business services, include legal services, Accounting, Auditing and Book keeping services, taxation services etc., but does not include secretarial services. The services being rendered by Company Secretaries are therefore spread over various sub-sectors such as financial intermediation services and auxiliary services thereof, professional services and computer and related services.

RESTRUCTURING PROFESSIONAL FIRMS FOR GATS REGIME

While many people like to refer to themselves as professionals the number of individuals who qualify

according to the formal definition of the term is relatively small. Strictly speaking, a professional is someone who has won the right to membership of a professional association by completing an accredited programme of examinations and training. However, in the broader perspective, a professional firm is any firm that uses the specialist technical knowledge of its personnel to create customised solutions to clients.

Until recently professional firms principally acted within a domestic market which was governed by national rules and protected by national barriers but now the boundaries between national economies are becoming blurred thus giving rise to new dynamics in terms of markets for professional services. This change is universal and is increasingly evident in every form of activity where increasingly external factors are becoming important in maintaining profitability, and ensuring national competitiveness. Accordingly, every enterprise has to deal with new forms of competition and new economic framework. The change is not confined to local markets or regional markets; it is in fact witnessed at international level. More and more global competitors are entering markets fuelling the intensity of competition. It is for this reason that restructuring through networking among professional firms becomes important in facing the onslaught of global competition which can be looked upon as providing opportunities and platforms for future growth.

Restructuring professional firms for GATS regime requires managing clients globally but not necessarily through global control. Therefore, consistency is prerequisite for professional firms to globalise. A firm which moves on the process of globalisation, needs to understand that relationships with clients across the globe may not be the same. Therefore, what is important for prospective global professional firms is not only providing the same service globally but achieving global service consistency.

Services have now become a powerful source of income in many countries including India. This applies to professional services as well. But even in the services industry there is an overriding need to deal with global forces, regulatory and otherwise, and to ensure that the benefits of the services industry are maximised not only regionally but internationally. Professional firms therefore need to look carefully at how well they compete? How to differentiate themselves in the marketplace and what are the ways to stand out from the competition? And how to communicate their differentiation? This differentiation can be indeed achieved by providing clients with value-added services; developing a positive

organization culture and identifying and implementing strategies that ensure long-term competitive advantage and profitability.

In the context of rapidly changing competitive environment, the value added services can be provided by the pace at which the firm responds to a client's needs. In fact the value added services for a professional firm is to bring value added benefits to the client by providing solutions with greater detail than peer firms, strongly demonstrating commitment to clients. This enhances the reputation of the professional firm and acts as differentiator for firm.

The organizational culture plays an essentially important role in the success of a professional firm. Culture is a stronger force for unity and coherence than any formal document. World-class organizations have been able to maintain consistent strategic and organizational approaches due to the strength of their cultures. Wherever these firms operate, their professionals share a culture that binds them into common practices, sustains their alignment, and gives them an advantage in attracting clients.

Top management's expressed beliefs, attitudes, and priorities set the tone for the firm's moral and behavioral norms, thus creating the firm's organizational culture. Cultures though generally created unconsciously based on the actions and values demonstrated by or the firm's founders, can also be planned and managed so as to attract and appeal to the best employees as well as serve the interests of stakeholders. A good organizational culture stimulates efficiency and regulation of the firm and also the employee performance and career longevity.

STRATEGIES TO LEVERAGE THE GATS REGIME

There is not doubt that any organization, be it a company, firm or any other kind of association, cannot move ahead effectively without a plan – a strategy. In this challenging and fast moving market place professional firms of all sizes and all specialties should therefore devise a specific strategic plan, develop methods for measuring their progress, and be ready to make changes as and when they are required. The following six areas could help professional firms develop strategies for growth, profitability and competitive advantage.

Strategic Alliances

It is important for professional firms to build synergies by making reliable strategic alliances to compete successfully and operate profitably. Professional firm should also develop capability and demonstrate its

ability to take on challenging, complex and sophisticated tasks and be able to complete them in a timely and professional manner. Partnering with reputed and dependable firms gives an assurance for, sustaining continuing growth, gaining new assignments and competing with larger firms.

Managing the Knowledge Pool

One of the most important factors contributing to the achievement of growth and prominence of a firm is to devise strategy to effectively manage and leverage its pool of knowledge.

All accredited professionals share a common body of codified knowledge acquired through professional training. A large part of their competitive advantage, therefore, derives from possessing a unique base of expertise. Traditionally, professional services firms have been regarded as organisations of highly trained, extremely technical specialists, who apply their esoteric knowledge to the creation of innovative and sophisticated solutions of clients' complex problems. It is believed that some firms operate successfully in this way. As a result, most highly expert professional firms remain small and specialised. A professional firm wishing to grow large must therefore learn to codify the esoteric and tacit knowledge accumulated within experienced staff and disseminate this throughout its organisational structure. If this knowledge can be expressed in terms of established procedures and applied to a wide range of client problems, the potential for leverage increases.

A study, sponsored by PricewaterhouseCoopers and the University of Florida Law School, looked at the state of knowledge management in law firms. The findings of the study are -

- Almost half (49%) of law firm respondents reported having initiated a Knowledge Management program
- Over 40% of law firm respondents believe the absence of a strategy is a barrier that prevents their respective organization from launching a Knowledge Management initiative.
- Law firm respondents indicated that searching across differing internal work product repositories was the most immediate and compelling concern regarding Knowledge Management.
- More than 40% of law firm respondents indicated that contributions to the Knowledge Management initiative are considered as part of the evaluation process.

- Over three-fourths of law firm respondents reported that standard legal forms and research memoranda are the most likely candidates for Knowledge Management repositories.
- Almost 70% of law firm respondents indicated documents in the knowledge repositories are between one and five years old.

Leverage the Technology

There is a revolution happening in the world today, and it is occurring faster than anyone expected. This revolution is not in technology, but in the way we interact with information. Examples of the changing ways in which we interact with information are everywhere: home and business networks, cell phones, cordless phones and tollbooths.

The overhead expenses of a professional firm account for more than one third of the cost. Therefore, as a part of strategy to reduce not only the cost but to create efficiencies of scale, a firm must leverage the technology. A focus on fully utilizing all applicable technology breakthroughs open important vistas for continuing growth, market leadership, and profitability for a professional firm.

Technology in recent years has reduced the costs and generally improved productivity. Technology allows creating virtual private networks providing direct access from anywhere. New technologies also allows operations to be managed efficiently by making internal documentation easily available without the need for printing and distribution. The Internet can be used to bring all the resources of the individual parts of the firm to each individual professional of the firm.

It is both compelling and confusing. There are some very fundamental reasons why this change is taking place—it allows us to work anytime, anywhere with all information; it is more personal and tailored; and also allows us all to move more freely. Let us have a look at some very interesting facts and figures that exemplify the importance of technology to individual and professional firms.

A recent Pew Foundation study highlighted the rapid growth in Americans' use of the Internet to find information. The findings of the study are -

- More than 8 out of 10 Internet users have searched the Internet to answer specific questions.
- Spurred by an increase in content and the

momentum of important news events in recent years, the online news population grew by 50%.

- The number of those who have used government Web sites grew by 56% between 2000 and 2002.
- Those who have searched for political news and information online grew by 57 between 2000 and 2002.
- The population of those who have done work or research for their job online (not including e-mail) grew by 45% between March 2000 and November 2002.

Leverage the Regulatory Change

It is important to for a professional firm to demonstrate its leadership in its area of specialization. This requires professional firm to keep a watch on legislative and regulatory changes impacting the client's plans, as they may not only slow the development process but can make development considerably expensive for clients. Therefore, an advance advise to client about the potential impact of regulatory changes and suitable prescription can help professional firm establish that it cares for clients time, money and energy.

Similarly, the critical thinking can permeate an entire organization if identified as a strategy for competitive advantage and growth. That means finding creative solutions, new ways to save clients time and money, approaches to identify problems before they occur etc. Critical thinking which includes good client listening, unbiased thinking, effective questioning, and creative problem solving can be accomplished at all levels in the firm individually or collectively.

Managing Star Professional

The Professional Service Firms with more than a trillion dollars in annual revenues are a major factor in the global economy and in the operations of myriad companies around the world that seek their help. But what makes these firms themselves work effectively is an issue to be deliberated. The management of professional firms presents a unique set of circumstances.

A firm's only means of revenue generation is its the pool of knowledge and expertise of its professional staff. Therefore, how it manages those people, how it aligns their individual goals with those of the firm, directly affects its ability to survive and prosper. The competitive advantage of a firm lies in its ability to get star professionals committed to the firm's strategy; to

manage them across the geographies, business lines, and generations; and to govern and lead them so that both the firm and such professionals prosper and feel rewarded.

PROFESSIONAL FIRM - A FUTURE ROLE MODEL

Professional firms embodying many of the qualities are relatively efficient mechanisms for developing and disseminating knowledge; create an environment in which highly motivated individuals can enjoy a reasonable degree of autonomy; and place dedication to client service above all other considerations. All this occurs in an environment, which enshrines mutual trust and collaboration within the professed value system. Professional firms represent a large and rapidly expanding segment within most industrialised economies. According to statistics from the Organisation for Economic Co-operation and Development (OECD), the professional services sector accounts for 17 per cent of all employment in the US and major western European countries. The sector has enjoyed annual growth of 15 per cent in revenue terms over recent years. The Price Waterhouse Coopers, the accountancy firm for example, with 155,000 professional staff worldwide and annual revenues of US \$ 15billion, if publicly quoted, would qualify as a Fortune 500 company.

There are various large professional firms with thousands of professional staff and billions of dollars of revenues. It is therefore advisable that a professional firm must operate like a business. To be effective as a business, a firm needs a strong and tight management team. Gone are the days when fiefdoms of information technology, marketing, finance, human resources, legal recruiting, professional development, information resources and administration operated independently within the firm. Today, professional firm must realize the importance of non professional team, such as Information Resources and Marketing and Sales. Without investment in information resources, and its strong management, a firm has a strategic disadvantage in today's competitive world. Marketing and Sales is the mechanism that drives the firm into the marketplace. Even the best company with a great product is nothing without a strong sales team. When the information resources and marketing and sales team work together, the results can be amazingly rewarding. The outward-looking teams working together help drive the strategic marketing goals of the firm and have a significant impact on firm revenue.

At present, the Code of Conduct mandatory for Company Secretaries prohibits direct or indirect soliciting

of professional work and the concept of marketing is foreign to the *modus operandi* of the profession. As the future is evolving under the GATS regime, slowly but surely the taboos of today will slacken as the days go. Till then the concepts of marketing and sales by a professional firm will remain innate qualities of the professional services and professional relationship building.

No firm today can be relaxed about driving its revenue through the top clients of the firm. The following is a list of critical steps:

1. Identify the top 50 to 100 clients of the firm.
2. Identify the primary business focus of corporate clients. By identifying this important information, a firm can begin to identify industries in which it has market share and strength, which will then help drive strategic marketing decisions for the future.
3. Create a tracking mechanism that allows the firm to stay current with published information about its clients, including the activities of key executives.
4. Develop client interview forms to learn about important client goals that may impact the firm.
5. Create targeted financial goals for building the firm's business with each company.
6. Manage information on an ongoing basis about the board members and executive leadership for dissemination to appropriate firm team members.

CODE OF CONDUCT – AN IMPERATIVE FOR PROFESSIONAL FIRMS

All professional firms conduct their operations within the framework of applicable professional standards, laws, regulations and internal policies. However, these can not govern all types of behaviour, therefore it is advisable to have a Code of Conduct based on the values of the firm. Everyone working in the firm must be under an obligation to follow the guidelines and practice the values contained in the Code. While the Code can not address every situation, the individuals should be given liberty to exercise good judgment and obtain guidance on proper business conduct. They should be encouraged to seek additional guidance and support from those responsible for conduct of affairs of the firm. The strength of every firm is the strength in collective

knowledge and sharing of that knowledge and experience.

MODEL CODE OF CONDUCT FOR PROFESSIONAL FIRMS*

The Code of Conduct provides the ethical framework on which the individuals should base their decisions as members of the organisation. The Code should be anchored in values and beliefs which the firm practices and underpin everything that the firm does. The Code of Conduct may be divided into categories containing guiding principles that should be used by everyone within the professional firm to guide their behaviour across all areas of activities.

It should be expected of everyone working for the professional firm to behave in accordance with the principles contained in the Code of Conduct. In case there is difficulty in understanding the principles contained the Code or in applying them, the concerned individual should be advised to consult an appropriately qualified colleague

1. Teaming

In working with each other all members of the firm should be advised to rely on each other to deliver a quality service to clients and for individual development. They should be advised to communicate openly and honestly; Nurture diversity, integrity, respect, and team spirit; Consult each other and value the different perspectives; Embrace diversity and multicultural experience as strengths of the firm; Respect one another and strive for an inclusive environment free from discrimination, intimidation, and harassment; and Encourage and support the professional development of colleagues and promote individual achievement and continuous learning; Expect and deliver feedback regularly, candidly and constructively.

2. Relationship with Clients and Others

In dealing with clients and others, it should be made clear to all members of the firm that no client or external relationship is more important than the ethics, values, integrity and reputation of the firm. The members of the firm should then commit themselves, as professionals, to uphold the trust reposed by others. They should be committed to delivering quality services that

* This Model Code of Conduct has been conceptualized and devised on the basis of Code of Conduct of Ernst & Young and Pricewaterhouse coopers.

reflect professional capabilities and are appropriate to the specific issues and needs of the clients.

They should uphold the professional standards and rules applicable to and actively work with the regulators who oversee the professional conduct to ensure that rules and standards meet the continuously changing needs of the market. The members of the firm should be clearly cautioned that they should avoid working with those whose standards are incompatible with firm's Code of Conduct but coordinate, as appropriate, with other members of the profession in matters of public interest; and recognise the responsibility for playing an active and positive role in building a successful and sustainable society .

Professional Objectivity and Independence

The objectivity being critical to professional independence, the members of the firm should be advised to maintain objectivity and affirm independence in relation to services. They should employ professional skepticism; reject inappropriate pressure from clients or others; and do not accept or give payments or items of value if this could reasonably be viewed as influencing conclusions or advice. The members of the firm should be advised to refrain from such relationships that impair, or may appear to impair, objectivity and independence.

Confidentiality

The confidentiality being the hall mark of the credibility, the firm should respect and protect confidential information obtained from, or relating to, its clients or third parties, as well as personal information about its people, in accordance with local laws and professional standards. The firm should obtain, develop and protect intellectual property in an appropriate manner and respect the restrictions on its use and reproduction.

CONCLUSION

The GATS regime requires Company Secretaries to show a visionary approach and a positive mindset that views the seemingly insurmountable pains and difficulties as opportunities and not as shackles. The days of global competition will be harder and longer; the path will be obscure as well as tiresome; but Company Secretaries will have to awaken the spirit of professionalism and build up future firms and the future of the firms with smiling and tireless zeal. The present Convention with involvement of professional leaders

from foreign countries is a momentous opportunity for national and International networking to build the future.

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CORPORATE CRIMINAL LIABILITY – THE ISSUE REVISITED IN THE CONTEXT OF RECENT SUPREME COURT DECISION

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INTRODUCTION

The debate on appropriateness of attributing criminal liability to corporations is far from over. There are views expressed in favour and against corporate criminal liability. The opponents argue that a corporation has no mind of its own, so it cannot demonstrate the moral turpitude required to establish criminal guilt. It is completely artificial to treat a corporation as if it had a blameworthy state of mind which, by definition, it cannot have. Furthermore, the impossibility of jailing an organization foils any attempt to attain the goals of deterrence, punishment and rehabilitation pursued by penal sanctions. The view in favour of corporate criminal liability - advocates that Corporations, are not mere fictions. They exist and occupy a predominant position within the society, and are as capable as human beings of causing harm. It is only just and consistent with the principle of equality before the law to treat them like natural persons and hold them liable for the offences they commit. Companies which have a major impact on the social life, must be required to respect the fundamental values of the society upheld by the criminal law.

Today the crime has shifted from almost solely individual perpetrators only 150 years ago, to white-collar crimes on an ever-increasing scale to acquire international character.

With the process of globalization and the growth of interdependence in economic, social and environmental activities by corporate entities, one of the most pressing global issues is the predominance of national and multinational corporations in economic transactions and their accountability. The corporate vehicle now occupies such a large portion of the industrial, commercial and sociological sectors that

amenability of the corporation to criminal law is as essential in the case of the corporation as in the case of the natural person.

The question of criminal liability of corporations illustrates the increasingly relative and functional interpretation of corporate responsibility. The complexities of corporate personality have nowhere been so troublesome as in the field of criminal law.

Two fundamental postulates of criminal law being presence of *mens rea* i.e. guilty mind and the principle of vicarious liability, the criminal law treats the company liable for an act of its agent or organ done with guilty intentions. It is well settled that in case the company contravenes or does not fulfil any statutory obligations it can be convicted of a statutory misdemeanor and there can be no other way except the indictment of the corporation itself. Although there is generally no vicarious responsibility in crime and people are responsible for their own acts, by means of fiction, a corporation could be made accountable as if it is its own act provided that the act is committed or omission is made by an organ of the company.

ORGANIC LIFE OF THE COMPANY AND CAPACITY TO COMMIT CRIME

Lord Denning in *Botton Engineering Company Ltd. v. Graham and Sons* (1957, 1 QB 15) 9 CA) observed that 'a company, in many cases is linked to a human body. It has a brain and a nerve center, which controls what it does. It has also hands, which hold the tools and act in accordance with directions from the Cenozoic. Some of the people in the company are mere servants and agents, who are nothing more than hands to do the work, and cannot be said to represent the mind or will. Others are directors and managers who represent the

* Principal Director, The ICSI. The views expressed are personal views of the author and do not necessarily reflect those of the Institute.

directing mind or will of the company and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.

In *Trustees of Dartmouth College v. Wood Ward* (1819) 17 US (4 wheat) 518, Chief Justice Marshal observed, that a corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of the law, it possesses only those properties which the charter of creation confers on it. This observation of Justice Marshal led to the concept that a corporation is an entity distinct from its members and officers, and with rights and liabilities of its own.

It was said that the corporate body could not : have criminal intent; be indicted by criminal procedure; be punished corporally; or be capable of certain criminal acts which were either void as *ultra vires* or by their very nature were inherently human. In most instances these barriers to liability have been overcome by judicial decisions and legislative enactments. The impossibility of harboring criminal intent, is a vestige of tradition stemming from the theory that a corporate body, without a mind and a will cannot harbor any intent in its ordinary capacity. However, most courts have now come to the settled position that a corporation may be capable of *mens rea*.

As most corporate crimes stem from economic objectives, it is entirely possible that a corporation might readily subject itself to the fine. But incalculable effect of conviction on the public attitude towards the corporation is probably the most forceful deterrent. There are corporate acts which are *ultra vires* and of no legal effect. The outlook sometimes prevails that a corporation can not be guilty of a particular crime, for that is *ultra vires* in itself, but it is not impossible to tear off logic to reason that no such crime exists. The considered range of these *ultra vires* acts has been so narrowed by the modern extension of corporate liability that the paths of this trend become a prime concern.

CORPORATE CRIMINAL LIABILITY – HISTORICAL PERSPECTIVE

Generally, the common law did not allow a corporation to be convicted of a crime. There were exceptions and these exceptions were based on the doctrine of respondent superior or vicarious liability – the master is liable for the conduct of his servant in the course of employment. The doctrine of vicarious liability was created in the law of tort in the seventeenth century in order to provide compensation to third parties and

justified on the ground that since the master acquired the benefits of the servant's work, he should also carry the burdens.

While the common law recognized the appropriateness of vicarious liability for tort compensation, it rejected vicarious liability for crimes since crimes required *mens rea* or guilty mind. The mere existence of the master-servant relationship was not considered to be a sufficient criterion for imputing personal fault to the master. However, there were three common law crimes which did not require *mens rea*. These include public nuisance, criminal libel and contempt of court. In these categories of offences, the courts applied vicarious liability, allowing the master (which could be either an individual or a corporation) to be convicted for offences of his servant. Apart from these vicarious liability exceptions, corporations were immune from liability under the criminal law.

The courts in early twentieth century began to dismantle the corporate immunity from criminal law by holding that words like everyone in criminal statutes could include corporations. Courts also rejected the argument that corporations cannot be held criminally liable for offences committed by their officers for reasons of being *ultra vires* unless those employees were expressly ordered to commit the act in question. However, the most challenging obstacle to imposing criminal liability on corporations was the difficulty of attributing *mens rea* to an artificial person - a corporation. The breakthrough came in 1915 when the House of Lords in *Lennard's Carrying Co. Limited, v. Asiatic Petroleum Co.* (1915) AC 705 at 713 (H.L.) laid down the general principle of directing mind (identification theory). In this case Viscount Haldane stated that "corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation". Subsequently, in *R v. Fane Robinson Ltd.*, (1941) 76CCC 196 at 203 (Alla C.A.), the Canadian Court applied the principle of directing mind and held that there is no reason why a corporation which can enter into binding agreements with individuals and other corporations cannot be said to entertain *mens rea* when it enters into an agreement which is the gist of a conspiracy and a false pretence.

THEORIES OF CORPORATE CRIMINAL LIABILITY

There are two theories, i.e. Theory of Vicarious

Liability and Identification; theories which have been used, in different contexts, to hold corporations criminally liable for true crimes and regulatory offences. The traditional theory of vicarious liability holds the master liable for the acts of the servant in the course of the master's business without proof of any personal fault on the part of the master. Whereas the identification theory recognises that the acts and state of mind of certain senior officers in a corporation are the directing minds of the corporation and thus deemed to be the acts and state of mind of the corporation. The corporation is considered to be directly liable, rather than vicariously liable under this theory. Let us examine, the various components of these two theories.

1. Doctrine of Vicarious liability

Generally the doctrine of vicarious liability recognises that a person may be bound to answer for the acts of another. Similarly in the case of corporations – the company may be liable for the acts of its employees, agents, or any person for whom it is responsible. The doctrine of vicarious liability developed originally in the context of tortious liability, was imported into the criminal law, when this type of offences were essentially absolute liability offences. [See for brief historical account of the importation of this common law doctrine in Canadian Law, *Canadian Dredge & Dock Co. v. The Queen* (1985) 1SC R662].

2. Identification theory

Contemplates an identity between the corporation and the persons who constitute its directing mind - the individuals whose duties within the corporation are such that, in the course of their duties, they do not take orders or directives from a higher authority within the organization. The commission of an offence by such person or group of persons identified with the organization and constitutes an offence by the corporation as well. The criminal liability of the corporation, like that of natural persons, indeed is primary and is not actually based on an application of the theory of vicarious liability.

The identification doctrine developed out of the perceived need to hold corporations liable for *mens rea* offences has created a pragmatic median between the extremes of total vicarious liability for all criminal acts and no corporate liability unless expressly authorized criminal acts. This doctrine stipulates that the actions and mental stage of the corporation found in the actions and state of mind of employees or officers of the corporation who may be considered the directing mind

and will of the corporation in a given sphere of the corporation's activities. A crucial point as to which employees or officers of a corporation are its directing mind for the purpose of the identification doctrine was considered and decided by the Supreme Court of Canada in *Dredge & Dock* case. The Supreme Court described the characteristics of the doctrine of identification theory, which may be summarized as follows :

1. It is a court adopted, pragmatic, but fictional device used to attribute a human element (mental state of mind) to an equally abstract entity called a corporation, for the purpose of including corporations within the control of the criminal law similar to natural persons.
2. If a corporate employee (or agent) is, in the Court's assessment virtually the directing mind and will of the corporation in the sphere of duty and responsibility assigned to the employee by the corporation, the employee's action and intent are the action and intent of the company itself, provided the employee is acting within the scope of his/her authority either express or implied.
3. The essence of the test is that the identity of the directing mind and the company coincide when the directing mind is acting within his/her assigned field of corporate operations i.e. field of operations may be geographic, or functional, or it may embrace the corporation's entire operations.
4. A corporation may have more than one directing mind. Where corporate activities are geographically widespread or diffused, it will be virtually inevitable that there will be delegation and sub delegation of authority from the corporate centre and therefore there will be several directing minds.
5. Since the actions and intent of the directing mind within his or her assigned field are merged with and become the actions and intent of the corporation, it is no defence for a corporation, to claim that,
 - (i) the Board of Directors or other corporate officers issued general or specific instructions prohibiting the criminal conduct;
 - (ii) the corporation and its directing mind are one, and thus the prohibition from one controlling arm of the corporation to

- another controlling arm can have no effect in law;
- (iii) the Board of Director had no awareness of the criminal conduct and did not authorize or approve it.
6. Although the directing mind and the corporation merge as one for the purposes of allowing the corporation to be convicted of an offence, both the directing mind and the corporation can each be prosecuted, convicted and punished for the offence.

Companies Act, 1956, is a juristic person and cannot be awarded the punishment of imprisonment and hence cannot be prosecuted for breach of Sections 277 and 278 of the Act". In *P. V. Pai v. R. L. Rinawma* (1993) 1 Com.LJ 314; (1993) 77 Comp.cas 179 (Kant) it was held that imprisonment alone was the punishment that could be imposed on a person found guilty and that the legislature intended that the offence under Section 277 should be met with punishment of compulsory imprisonment and fine, and courts have no jurisdiction to impose fine only and if that is done it would be altering the very scheme of the Act.

Corporate Criminal Liability – Indian Context

The question whether a company could be prosecuted for an offence for which mandatory sentence of imprisonment is provided continued to agitate the minds of the courts and jurists and the law continued to be the old law despite the recommendations of the Law Commission and the difficulties were expressed by the superior courts in many decisions.

Different High Courts have taken different views on this question. In *State of Maharashtra v. Syndicate Transport Co. (P) Ltd.* (1964) 66 Bom L.R. 197; AIR 1964 Bom 195, the Bombay High Court held that the company cannot be prosecuted for offences which necessarily entail consequences of a corporal punishment or imprisonment and prosecuting a company for such offences would only result in the court stultifying itself by embarking on a trial in which the verdict of guilty is returned and no effective order by way of sentence can be made. In *Kusum Products Ltd. v. S.K. Sinha* (1980) 126, ITR 806 (Cal.) the Calcutta High Court took the view that even though the definition of "person" under section 2(31) of the Income Tax Act is wide enough to include a company or a juristic person, the word "person" could not have been used by Parliament in Section 277 (Income Tax Act) in the sense given in the definition clause. The Calcutta High Court further held that the intention of Parliament is otherwise because imprisonment has been made compulsory for an offence under Section 277 of the Act and a company being a juristic person cannot possibly be sent to prison and it is not open to a court to impose a sentence of fine or not to award any punishment if the court finds the company guilty under the said section, and if the court does it, it would be altering the very scheme of the Act and usurping the legislative function.

In *Badsha v. ITO* (1987) 168 ITR 332(Ker) Justice Thomas, J., following the decision of the Allahabad High Court in *Modi Industries Ltd. v. B. C. Goel* (1983) 144 ITR 496(All) held that a company registered under the

The Supreme Court in *Asstt. Commissioner v. Velliappa Textiles Ltd.* (2003) 7SCC 405 held by a majority decision that the company can not be prosecuted for offences which require imposition of a mandatory term of imprisonment coupled with fine. The Supreme Court further held that where punishment provided is imprisonment and fine, the court can not impose only fine. The Supreme Court in *ANZ Grindlays Bank Ltd. v. Directorate of Enforcement* (2004) 6 SCC 531 held that the correctness of the decision in *Velliappa Textiles Ltd.* case requires reconsideration by a constitution Bench and thus referred the matters to a constitution Bench for an authoritative pronouncement on the subject.

Evolution of Corporate Criminal Liability in India

In *Oswal Vanaspati & Allied Industries v. State of U.P.* 1993 1 Comp LJ 172, the Full Bench of the Allahabad High Court held that a company being a juristic person cannot obviously be sentenced to imprisonment as it cannot suffer imprisonment. The question that requires determination is whether a sentence of fine alone can be imposed on it under Section 16 of the Act or whether such a sentence would be illegal and hence cannot be awarded to it. It is settled law that sentence or punishment must follow conviction and if only corporal punishment is prescribed a company which is a juristic person cannot be prosecuted as it cannot be punished. If, however, both sentence of imprisonment and fine is prescribed for natural persons and juristic persons jointly then though the sentence of imprisonment cannot be awarded to a company, the sentence of fine can be imposed on it. Thus, It cannot be held that in such a case the entire sentence prescribed cannot be awarded to a company as a part of the sentence, namely, that of fine can be awarded to it. Legal sentence is the sentence prescribed by law. A sentence which is in excess of the sentence prescribed is always illegal but a sentence which is less than the sentence prescribed may not in all cases be illegal."

Recently, The Supreme Court in *Standard Chartered Bank & Others v. Directorate of Enforcement & Others* (2005) 4 SCC 530, considered the issue as to whether a company, or a corporation, being a juristic person, could be prosecuted for an offence for which mandatory sentence of imprisonment and fine is provided; and when found guilty, whether the court has the discretion to impose a sentence of fine only. The Supreme Court held that there is no dispute that a company is liable to be prosecuted and punished for criminal offences. Although there are earlier authorities to the effect that corporations cannot commit a crime, the generally accepted modern rule is that except for such crimes as a corporation is held incapable of committing by reason of the fact that they involve personal malicious intent, a corporation may be subject to indictment or other criminal process, although the criminal act is committed through its agents.

In the *Standard Chartered Bank* case the Supreme Court observed that as in the case of torts, the general rule prevails that the corporation may be criminally liable for the acts of an officer or agent, assumed to be done by him when exercising authorised powers, and without proof that his act was expressly authorised or approved by the corporation. In the statutes defining crimes, the prohibition is frequently directed against any "person" who commits the prohibited act, and in many statutes the term "person" is defined. Even if the person is not specifically defined, it necessarily includes a corporation. It is usually construed to include a corporation so as to bring it within the prohibition of the statute and subject it to punishment.

Distinction between Strict Liability and Absolute Liability

In as much as all criminal and quasi-criminal offences are creatures of statute, the amenability of the corporation to prosecution necessarily depends upon the terminology employed in the statute. In the case of strict liability, the terminology employed by the legislature is such as to reveal an intent that guilt shall not be predicated upon the automatic breach of the statute but on the establishment of the *actus reus*, subject to the defence of due diligence. The law is primarily based on the terms of the statutes. In the case of absolute liability where the legislature by the clearest intendment establishes an offence where liability arises instantly upon the breach of the statutory prohibition, no particular state of mind is a prerequisite to guilt. Corporations and individual persons stand on the same footing in the face of such a statutory offence. It is a case of automatic primary responsibility. Therefore, as regards corporate criminal

liability, there is no doubt that a corporation or company could be prosecuted for any offence punishable under law, whether it is coming under the strict liability or under absolute liability

The Supreme Court further observed that it is true that all penal statutes are to be strictly construed in the sense that the court must see that the thing charged as an offence is within the plain meaning of the words used and must not strain the words on any notion that there has been a slip that the thing is so clearly within the mischief that it must have been intended to be included and would have been included if thought of. All penal provisions like all other statutes are to be fairly construed according to the legislative intent as expressed in the enactment. See *Tolaram Relumal v. State of Bombay*, (1955) 1 SCR 158; *Giridheri Lal Gupta v. D.H. Mehta*, (1971) 3 SCC.

In fact, there are a series of offences under various statutes where the accused are also liable to be punished with custodial sentence and fine. As per the scheme of various enactments and also the Penal Code, mandatory custodial sentence is prescribed for graver offences. If the appellants' plea is accepted, no company or corporate bodies could be prosecuted for the graver offences whereas they could be prosecuted for minor offences as the sentence prescribed therein is custodial sentence or fine. It could not be the intention of the legislature to give complete immunity from prosecution to the corporate bodies for the grave offences.

If the custodial sentence is the only punishment prescribed for the offence, the company being a juristic person cannot be prosecuted for the offence for which custodial sentence is the mandatory punishment. But when the custodial sentence and fine are the prescribed mode of punishment, the court can impose the sentence of fine on a company which is found guilty as the sentence of imprisonment is impossible to be carried out. It is an acceptable legal maxim i.e the *impotentia excusat legem* law does not compel a man to do that which cannot possibly be performed. And "all civilized systems of law import the principle that *lex non cogit ad impossibilia...*". So also "if an enactment requires what is legally impossible it will be presumed that Parliament intended it to be modified so as to remove the impossibility element". As the company cannot be sentenced to imprisonment, the court cannot impose that punishment, but when imprisonment and fine is the prescribed punishment the court can impose the punishment of fine which could be enforced against the company.

The Supreme Court explained that there is no blanket immunity for any company from any prosecution for serious offences merely because the prosecution would ultimately entail a sentence of mandatory imprisonment. The corporate bodies, such as a firm or company undertake a series of activities that affect the life, liberty and property of the citizens. Large-scale financial irregularities are done by various corporations. The corporate vehicle now occupies such a large portion of the industrial, commercial and sociological sectors that amenability of the corporation to a criminal law is essential to have a peaceful society with stable economy. Therefore, there is no immunity to the companies from prosecution merely because the prosecution is in respect of offences for which the punishment prescribed is mandatory imprisonment and fine. The Supreme Court in thus Velliappa Case has given new dimension to the corporate criminal liability and favoured the new thinking prevalent in other parts of the world.

In Australia, France (Penal Code of 1992), the Netherlands (the Economic Offences Act, 1950 and Article 51 of the Criminal Code) and Belgium (in 1934 Courde Cassation) as cited in Velliappa case, the Supreme Court observed that in all these jurisdictions, the view that prevailed was that, where a statute imposes mandatory imprisonment plus fine, such a provision would not enable the punishment of a corporate offender. If the legislatures of these countries stepped in to resolve the problem by appropriate legislative enactments giving an option to the courts to impose fine in lieu of imprisonment in the case of a corporate offender, we see nothing special in the Indian context as to why such a course cannot be adopted. Merely because the situation confronts the courts in a number of statutes, the court need not feel deterred in construing the statute in accordance with reason."

CONCLUSION

There is an apparent need to adapt the notion of fault to the structure and particular *modus operandi* of corporations. The existing mechanisms used to attribute criminal liability to corporations are but a partial solution, and should be improved.

This cannot be achieved in any meaningful way unless some serious thought is given to a number of fundamental questions, including the ability of criminal sanctions to effectively fulfill, in the corporate context,

the objectives of punishment, deterrence and rehabilitation traditionally associated with them. It is often argued in opposition to corporate criminal liability that the imposition of fines provides no guarantee that delinquent conduct will be deterred. The fines imposed on corporations are often minimal in comparison with the devastating effects of their wrongful acts, and virtually amount to a cost of doing business. But there is also a concern that excessive fines can have perverse effects that may have to be borne by innocent shareholders, creditors, employees or consumers. However, the preceding discussion makes it ample clear that in view of imposing role of corporations in economic, political and social spheres, the jurisdiction around the world are thinking in harmonious fashion in imposing criminal liability on corporations. As various jurisdictions have given this a statutory status, in India too the Government will consider the same in the light of Reports of Law Commission and the Supreme Court decision in Standard Chartered case.

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GLOBAL MARKETING AND BRAND BUILDING OF COMPANY SECRETARIES

BALWANT KULKARNI*

GLOBAL MARKETING

Globalisation of Company Secretaries' services involves the commercial aspect of marketing these services to clients and companies from abroad establishing their presence in India as well as those exist for conducting business in other countries of the world. These companies and business houses need to appreciate the value of services rendered by Company Secretaries. Although proactive marketing of services is banned as at present under the professional code of conduct, through interaction with such companies and businesses the result of their dependence on the services of independent professionals like Company Secretaries is achieved. A constant touch and continued interaction with such businesses, Company Secretaries do achieve recognition to and appreciation of the services rendered by them through their public practice activities. Now that Company Secretaries will have to compete globally they would not be able to escape the rules of marketing of professional services and the development of the skills of marketing of professional services that the multi-national professional firms have perfected over the years.

Service marketing has many subtler nuances as compared to the marketing of hard products. In fact it is necessary to turn services into and package them as products before presenting them as a sales proposition. The packaging should be clear and appealing to the physical as well as the discerning inner eye of the prospect. The characteristics, the unique selling proposition, the value-adding propensities, the advantages offered by the service-product should be clear and palpable in all aspects when the product is positioned in the service market. The preparation and presentation of the service-product should be preceded by market research, competition research, customer-need research. The after-sale offerings should also be clarified in the presentation. There could also be test marketing or even better Company Secretaries should

recognize the importance of and methodology of co-creation of value with the customer.

Company Secretaries' firms should also develop customer-centric culture.

Customer centric culture includes:

- understanding what customers seek;
- mapping competition;
- evolving a positioning strategy;
- bringing the value proposition alive;
- keeping track of changing needs.

They must realize that customers alone pay costs and provide profits. No longer is a product differentiator from a competitor, but it is human touch in the interaction with customers that matters.

From an organization's perspective [in connection with internal customer culture], it is important to create leadership at every level. Mistakes have to be tolerated and differences [of opinion] within an organization must be appreciated. Professional firms also have to manage their daily processes, as if they [the processes] were actual villains in creating dissatisfied customers.

Feedback is an integral part of services and complaints are like gifts—the option is to effectively manage them in order to survive, sustain and grow.

When a professional firm researches the market and the customers it must bear in mind that research cannot take the place of insights gleaned from observing people. Insights operate at two levels in marketing. The first is as part of the strategy and feeding into the client brief. This is classically the function of the account planner. The insight at this stage is properly a part of the target audience understanding in terms of what motivates them, and why the service's selling proposition would be of interest to them.

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The second is as part of the creative idea. These insights are sharp and form the core of the approach by which the selling proposition is magnified. In great creative marketing, the idea is the insight and the insight is the idea. Company Secretaries need to practise 'insightfulness' which is the habit of observing people around them, what they are upto, what they are talking about and what seems to be turning them on. These insights give the service-product idea.

Now if we turn to creation of value that any service needs to offer we may turn to the observations of a very successful service company from India:

Inaugurating the convention on "Beyond Creating Value" Mr Raju, Chairman, Satyam, said the need of the hour was leadership from the manufacturing sector to create value in the services sector. The concept of individuals doing what they have been told to do as a professional is losing relevance in the services sector. Satyam has adopted a "full lifecycle value-creation model", which involves three concepts- thinking, doing and communicating.

Knowledge economy demanded that companies put a premium on their soft assets such as brand value and goodwill among customers rather than on hard assets like machines and materials.

Global GDP and wealth creation this century will be due to the creation of new products and services. This meant that all existing products and services available will get commoditized, resulting into a fall in prices and reduction in their exchange values.

WTO

Collectively, the profession world-over requires to push for its brand identity. WTO is the right formal forum for this purpose.

Another aspect of globalisation of company secretarial services is to have that Head separately recognized as a professional service under the WTO portals. Negotiations through national offers and counter-offers under the four Modes of General Agreement on Trade in Services take place with reference to the various categories of services that are rendered across national borders. A research through the United Nations Central Product Classification adopted by the WTO for classification of, *inter alia*, services for negotiations under the four Modes under the GATS.

An Executive Summary of the Approach Paper published by the WTO for securing openness of cross-border trade in services will be an interesting reading

for those who would put in their weight, indirectly or directly, in the corridors of the WTO negotiations. The Summary reads as follows:

- (i) Cross-border trade in services is growing rapidly, with India among the most dynamic exporters. Despite the substantial global benefits from such trade, it is possible that the adjustment pressures created in importing countries could provoke a protectionist backlash - some signs of which are already visible in procurement and regulatory restrictions. The current negotiations under the Doha Development Agenda offer an opportunity to preempt protectionism. This is best accomplished, not by perpetuating the WTO's decision on duty-free electronic commerce, but by ensuring that all WTO Members make comprehensive commitments on cross-border trade in services under the General Agreement on Trade in Services (GATS).
- (ii) Previous experience of the GATS negotiations and initial offers of access by Members in the current round suggest, however, that comprehensive coverage will not be easy to accomplish, for two reasons. First, in the current GATS framework, the market access commitments of WTO Members apply only to sectors explicitly listed by them, which places a heavy burden on the services classification scheme used by Members. The existing classification scheme does not cover all the services in which India has an export interest. Revising it does not offer a durable solution because no classification scheme can keep up with changes in technology, business practices and skills, and anticipate the ever-widening range of new services that India will export. Second, WTO Members traditionally negotiate access in services through the request-and-offer approach which involves extracting commitments trading partner by trading partner, sector-by-sector. This is a painful task with high costs in terms of negotiating resources, and it will not be particularly fruitful because India does not necessarily have much to offer each country to which it may one day sell services.
- (iii) More innovative approaches are necessary, and should be possible, since the issue in cross-border trade is not to induce countries to eliminate protection but simply to lock in their

currently open regimes. The paper suggests two possibilities. The less ambitious Option 1 is for WTO Members to make liberalizing commitments on the basis of a model schedule designed to cover the information technology and business process outsourcing (BPO) services that are at the heart of the current trade boom. An essential step is to map the IT and BPO services being traded today into the existing GATS classification scheme, a task this note undertakes.

- (iv) In the more forward looking Option 2, both the classification and strategic problem may be addressed through an innovative proposal requiring that all (or a critical mass of) WTO Members commit not to impose any restrictions on cross-border trade in any except a mutually agreed (narrow) set of services. Such a proposal would combine two elements: a negative list approach for cross-border trade that finesses the whole classification issue by treating all services as covered except the explicitly excluded few; and a "formula" approach that requires all WTO Members (or a critical mass) to undertake a specified level of commitments.
- (v) The paper identifies these concrete options in order to advance discussion and facilitate consultations, domestically and with trading partners, on how best to secure free cross-border trade in services. It will also be necessary to consider complementary initiatives on regulatory transparency, domestic regulation, and the clarification of issues like applicable jurisdiction, to achieve the aim of unfettered cross-border trade in services.

Although one way to establish cross-border recognition of Company Secretary's services is for the ICSI to enter into Mutual Recognition Agreements with corresponding Institutes in other countries, this will only be a bilateral recognition. The growth in Company Secretary services at the world or multilateral level will not take place through this method. The growth that is required for the profession to prosper at the global level calls for a multilateral recognition. A visible offer or counter-offer or comprehensive commitment in corporate governance and company secretarial services through the WTO negotiations would go a long way.

In India, the statute has recognized services of the practising Company Secretary through section 2 of the Company Secretaries Act, 1980.

Services of Company Secretary

Section 2(2) of the Company Secretaries Act, 1980 has prescribed the following areas of practice for a company secretary in practice:

- (a) to engage himself in the practice of the profession of company secretaries to, or in relation to, any company; or
- (b) to offer to perform or perform services in relation to the promotion, formation, incorporation, amalgamation, reconstruction, re-organization or winding-up of companies; or
- (c) to offer to perform or perform such services as may be performed by:
 - (i) an authorized representative of a company with respect to filing, registering, presenting, attesting or verifying any documents (including forms, applications, and returns) by or on behalf of the company;
 - (ii) a share transfer agent;
 - (iii) an issue house;
 - (iv) a share and stock broker;
 - (v) a secretarial auditor or consultant;
 - (vi) an adviser to a company on management, including any legal or procedural matter falling under the Capital Issues (Control) Act, 1947, the Industries (Development and Regulation) Act, 1951; the Companies Act, 1956; the Securities Contracts (Regulation) Act, 1956; any of the rules or bye-laws made by a recognized stock exchange, the Monopolies and Restrictive Trade Practices Act, 1969; the Foreign Exchange Regulation Act, 1973; or under any other law for the time being in force.
 - (vii) to issue certificates on behalf of, or for the purposes of a company; or
- (d) to hold himself out to the public as a company secretary in practice; or
- (e) to render professional services or assistance with respect to matters of principle or detail relating to the practice of the profession of company secretaries; or
- (f) to render such other services as, in the opinion of the Council are or may be rendered by a Company Secretary in practice; The words "to be in practice", with their grammatical variations and cognate expressions, shall be construed accordingly.

When India entered into Comprehensive Economic Cooperation Agreement a Joint Study Group was established to study the scope of trade in services between the two countries. The findings of the study group are indicative of the scope for services that can be rendered by professionals from India and Singapore bilaterally.

FINDINGS OF JOINT STUDY GROUP

- (a) Singapore is a labour scarce country and maintains a policy of being open to foreign talent. India is a rich source of internationally competitive skilled professionals, which can be absorbed by Singapore's knowledge-based sectors. However, the cross-country movement of professionals is restricted by barriers such as registration requirements, nationality and citizenship requirements and the lack of mutual recognition of qualifications.
- (b) Singapore's export of services to India grew by 41.7 per cent from S\$585 million (US\$361 million) in 1998 to S\$830 million (US\$512 million) in 2000. India's export of services to Singapore grew by 34.5 per cent from S\$293 million (US\$181 million) in 1998 to S\$394 million (US\$243.2 million) in 2002.
- (c) The Indian economy is expected to grow at a rate of around 8 per cent in the next 10–15 years. This would require an investment of US\$429 billion over the same period in the infrastructure sector alone and India will benefit from Singapore's experience and technical know-how in infrastructure services.
- (d) Indian companies have shown interest in investing in Singapore. Since Singapore is developing as a regional and international hub for various services, such as IT, finance, education and health, access to the Singapore market will widen the global marketing network of Indian companies.

SERVICE SECTOR STATISTICS

Information about trade in commercial services in 2004 points to a faster growth in commercial services trade in the Asian Economies than in North American or European Economies.

IMF – BOP Statistics, 2004 reports that the dollar value in commercial services increased to \$2.10 trillion [16% year on year] in 2004. This was led by strong recovery in transportation and travel services.

INVESTMENT IN SERVICE SECTOR

World Investment Report, 2004 indicates that investment in services (mode 3) has been on the rise in the last decade and was an estimated \$4 trillion in 2004, 60% of world FDI stock.

Services represent 20% of total world trade but account for over two-thirds of world GDP.

Yet, inspite of the scope available, a serious, yet, unintended error has crept in when the Annexure relating to list of professionals was being finalized as a part of the Comprehensive Economic Cooperation Agreement with Singapore.

The error has occurred, it may be surmised, because a general multilateral recognition to the services of Company Secretaries was not on the anvil through the UN or the WTO apparatus.

REFERENCE TO CS IN CECA

CECA Between India and Singapore

Annexure 9A – List of Professionals

Item 112 – “Company Secretaries who are Accountants”

A study of the UN Central Product Classification that is adopted by the WTO was carried out with specific emphasis on Service Heads that covered services of Practising Company Secretaries as enunciated in the Company Secretaries Act, 1980. The results of the study are as follows:

UNCPC AND WTO CLASSIFICATION

The classification of service sectors in this schedule is based on the 1991 provisional Central Product Classification (CPC) of the United Nations Statistical Office unless otherwise indicated by the absence of a CPC number. The ordering reflects the Services Sectoral Classification list as used in the GATT document MTN.GNS/W/120 dated 10 July 1991. The scheduling of specific commitments follows the guidelines stated in GATT documents MTN.GNS/W/164 dated 3 September 1993 and MTN.GNS/W/164/Add.1 dated 30 November 1993.

EXPLANATION TO RELEVANT SUB-CLASSIFICATIONS UNDER PROVISIONAL CPC

Subclass : 86119 - Legal advisory and representation services in judicial procedures concerning other fields of law.

Legal advisory and representation services during the litigation process, and drafting services of legal documentation in relation to law other than criminal law. Representation services generally consist of either acting as a prosecutor on behalf of the client, or defending the client from a prosecution.

Subclass: 86120 - Legal advisory and representation services in statutory procedures of quasi-judicial tribunals, boards, etc.

Legal advisory and representation services during the litigation process, and drafting services of legal documentation in relation to statutory procedures. Generally, this implies the representation of a client in front of a statutory body (e.g. an administrative tribunal). Included are both the pleading of a case in front of authorized bodies other than judicial courts, and the related legal work. The latter comprises research and other work for the preparation of a non-judicial case (e.g. researching legal documentation, interviewing witnesses, reviewing reports), and the execution of post-litigation work.

Subclass : 86130 - Legal documentation and certification services

Preparation, drawing up and certification services of legal documents. The services generally comprise the provision of a number of related legal services including the provision of advice and the execution of various tasks necessary for the drawing up or certification of documents. Included are the drawing up of wills, marriage contracts, commercial contracts, business charters, etc.

Subclass : 86190 - Other legal advisory and information services

Advisory services to clients related to their legal rights and obligations and providing information on legal matters not elsewhere classified. Services such as escrow services and estate settlement services are included.

Subclass : 86501 - General management consulting services

Advisory, guidance and operational assistance services concerning business policy and strategy and the overall planning, structuring and control of an organization. More specifically, general management consulting assignments may deal with one or a combination of the following: policy formulation, determination of the organizational structure that will most effectively meet the objectives of the organization, legal organization, strategic business plans, defining a management information system, development of

management reports and controls, business turnaround plans, management audits and other matters which are of particular interest to the higher management of an organization.

Subclass : 86509 - Other management consulting services

Advisory, guidance and operational assistance services concerning other matters. These services include industrial development consulting services, tourism development consulting services, etc.

Subclass : 86602 - Arbitration and conciliation services

Assistance services through arbitration or mediation for the settlement of a dispute between labour and management, between businesses or between individuals.

Exclusions : Representation services on behalf of one of the parties in the dispute and consulting services in the field of labour relations are classified in subclass 86190 (Other legal advisory and information services), 95110 (Services furnished by business and employers organizations) and 95200 (Services furnished by trade unions), respectively.

Subclass : 81312 - Financial market regulatory services

Monitoring and enforcement services of rules and regulations in the financial markets pertaining to deposit and loan services and respective institutions, and to securities markets and participants in those markets.

Subclass : 81319 - Other financial market administration services

Administrative services to security or commodity holders, brokers or dealers, e.g. security custody services, financial reporting services, and other market administration services, not elsewhere classified.

Subclass : 81322 - Securities issue and registration services

Administrative services related to the issue and registration of securities, e.g. provided in issuing stocks or bonds.

Subclass : 81329 - Other services related to securities markets

Information services on stock quotations and information dissemination services through documents or electronic means. Other services related to securities markets, not elsewhere classified.

Cross Border Supply

At present, services negotiations are at a critical juncture at the WTO as is well known. Supply of services through Mode-1 i.e Cross Border Supply is an area of core interest for India. Technological developments in the recent past have made possible commercially meaningful trade in a number of sectors and sub-sectors that was earlier not possible. Further, the strong economic pressures on multinational corporations to cut costs have also led to outsourcing of a number of services.

Under the GATS, trade through Business Process Outsourcing is undertaken through the electronic modes of delivery i.e Mode 1. The Services provided through IT Enabled Services cover a wide range and cut across a number of service sectors such as professional services, Telecommunication Services, Business Services, Education Services, Distribution service, Tourism Services, Transport Services etc. It would also cover activities such as back office operations, call centers, medical transcription etc. in which India has already developed world standard abilities.

According to NASSCOM estimates, in 2002, the global BPO market was valued at US\$ 773 billion. This is expected to rise to US\$ 1 trillion by 2006. India's BPO exports in 2003-04 amounted to US\$ 3.6 billion, recording a growth of 54% over the previous year. The projected BPO exports from India in 2008 are US\$ 22 billion.

When the Uruguay Round began, Member countries took commitments in a number of service sectors, which could be supplied through Cross Border Supply, which led to a liberal regime through this Mode of supply. However, there are still gaps in commitments both because in the Uruguay Round many of the services could not be traded cross border and because the existing classification does not adequately cover many services that are being supplied through this Mode. It has been India's stand that Members should lock in current liberal regimes in Cross Border Supply as well as plug the gaps in commitments.

Even the steps above may, however, not be enough to push forward our agenda in Cross Border Supply. In particular, we need to focus on the following:

Whether there are specific services, which have a lot of potential for commercial trade even now, but are not adequately reflected in the current classification.

Assess the commercial potential for trade of the activities described in the attached classification and

whether India can competitively supply these services electronically.

Assess whether technological developments in the future may give rise to new services, which can be traded commercially

It is, therefore, necessary to examine each of the services in the enclosed list from the point of view of the parameters listed above.

In light of the above discussion, it is clear that BPO/ITES and off-shoring are likely to continue as major thrust areas from India's point of view. It is, therefore, essential that we negotiate for market access in Cross Border supply with our major trading partners. Specifically, since it is agreed that both developing and developed countries are likely to benefit, it will be in everybody's interest to eliminate the uncertainties in the business environment and the political backlash that may intensify in the future. One way to do this is bind the existing commitments under GATS and make further liberal commitments in Cross Border Supply as stated above.

COMPANY SECRETARY BRAND

Company Secretaries know their identity; they know what they can do; they know what they can achieve.

But they need to make an effort to reach out to the world with the Brand 'Company Secretary' and its Brand Value.

Sensing this the Council of ICSI in its collective wisdom took the step forward in May 2004 itself by passing a Resolution to take up the matter through the Ministry of Commerce, Govt. of India, echelons to move the WTO corridors in Geneva through the Indian Mission thereby mobilizing support of parallel Institutes in various other countries.

ICSI COUNCIL RESOLUTION

The Council noted with concern that the Corporate Governance, Compliances and Secretarial Advisory Services were nowhere recognized as a separate Head in the Services Sectoral Classification List of the WTO.

The Council unanimously resolved that the Company Secretaries/Chartered Secretaries and Administrators profession may recommend and pursue the introduction in the Services Sectoral Classification List of the WTO, the following new services namely:

CORPORATE GOVERNANCE, COMPLIANCES AND SECRETARIAL ADVISORY SERVICES
Corporate Secretarial Services**Secretarial Audit and Compliance Audit Services****Certification Services****Corporate Governance Services****Corporate Advisory Services****CORPORATE SECRETARIAL SERVICES**

This sub-Services sectoral Classification of the WTO to include promotion, formation and incorporation of companies and matters related therewith; filing, registering any document including forms, returns and applications by and on behalf of the company as an authorized representative; maintenance of secretarial records, statutory books and registers; arranging board/general meetings and preparing draft minutes thereof and all work relating to shares and their transfer and transmission.

SECRETARIAL AUDIT AND COMPLIANCE AUDIT SERVICES

This sub-Services sectoral Classification of the WTO to include all statutory Secretarial Audits, Compliance Audits and Compliances under Company, corporate and Securities Laws including regulations and guidelines, by the members of the Company Secretaries/Chartered Secretaries and Administrators profession.

CERTIFICATION SERVICES

This sub- Services sectoral Classification of the WTO to include all statutory certification services for which the members of the Company Secretaries/Chartered Secretaries and Administrators profession are authorized.

CORPORATE GOVERNANCE SERVICES

This sub-Services sectoral Classification of the WTO to include all services relating to advising on good governance practices and compliance of Corporate Governance norms as prescribed by the Companies Legislations of different countries, Corporate, Securities and other legislations of different countries for the time being in force.

CORPORATE ADVISORY SERVICES

This sub-Services Sectoral Classification of the WTO to include services relating to:

Advising Companies on management including any legal and procedural matters falling under Companies Legislations , Securities Laws and Corporate Laws of different countries.

Appearing as an authorized representative before quasi-judicial bodies and tribunals

Due diligence

Corporate restructuring

Foreign Collaborations and Joint Ventures

Project Planning

CONCLUSION

Global realities are different. Competition and marketing at that level require different approach, a different attitude, a new work culture and a dynamic work plan. Establishment as service professionals in other countries and with foreign clientele will need a retraining and an inculcation of new skills with a serious studied approach. The ICSI has taken a lead; students and members have also started catching up. The momentum needs to be further geared up, polished and speeded up if the brand value is to be built up for Company Secretaries across national borders.

THE INDO-SINGAPORE TREATY AND GLOBALISATION OF COMPANY SECRETARIES FIRMS

BALWANT KULKARNI*

A few thoughts on going multi-disciplinary while restructuring professional firms for GATS regime read as follows : Recently in an interview to the Economic Times, the CEO of the Boston Consulting Group Mr. Hans-Paul Buerkner remarked that going to and beyond the boundaries of various disciplines through networking will make the future firm happen. In fact, BCG is now adding scientists, biotech professionals, anthropologists, neurologists, medical doctors, philosophers and even theologians to its rolls and they are expected to lead change. It is no use narrowing strategic management to tools and techniques. Tools may be able to help you take certain steps but they essentially provide a standard approach. In giving advice to industry there is no point restating the industry logic and following the industry benchmarks. These, in a way, defeat the very purpose of organizational change in restructuring professional firms Company Secretaries need to lead a dynamic organizational change. Therefore, it is important for them to go beyond logic, think out of box and try things to which people will say "it's crazy". Collecting synergies and ideas from academics and professionals from diverse fields is therefore important to break boundaries and re-establish the power of ideas. Developing the concept of networked organizations and the economics of integration will help create a future firm that can succeed in the GATS regime. A multi-disciplinary professional firm of the future will showcase an organization where individuals and groups act as nodes and links across boundaries in order to work together for a common purpose. It will have multiple leaders, lots of voluntary links and interacting loops. Such a firm will be a flatter organization where every person interacts regularly with others and shares knowledge.

An example can be found in Toyota's managerial methods and the open-source traits of its production system analogous to the open- source software Linux.

The desideratum of building such an organization is "modularity" as opposed to the "re-engineering" cherished in the nineties. Re-engineering was about thinking linearly: managing end-to-end processes instead of discrete functions. That approach fostered focused efficiency but inhibited variety and adaptability.

Modularity is the reverse: sacrificing static efficiency for the recombinant value of options. It is necessary to think modular teams as well as modular processes. The finer, the better.

The thoughts in this Paper ideate a multi-disciplinary professional approach that such a Company Secretaries' firm of the future would venture to model itself on while going global under the GATS regime.

TAKING SHAPE

As the Comprehensive Economic Cooperation Agreement [CECA] between India and Singapore is getting inked the Economic Times of June 17, 2005 reports that the Government of India has decided to allow three Singapore Banks free access to Indian market, with operational freedom at par with domestic banks.

Development Bank of Singapore, United Overseas Bank and OCBC Bank have been formally listed as part of the overall CECA. The government has also put in place a mechanism to ensure that Singapore banks that have access to the Indian market are not used as a proxy by American or European banks to get the same privileged market access that India-Singapore CECA allows. The CECA is being signed by June end. The Singapore banks will also be allowed to acquire private Indian banks under the existing foreign investment policy framework. These banks will be subject to the overall restriction imposed on foreign banks. Foreign banks cannot exceed 15% of the total banking sector assets.

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However there is enough headroom as the current share of foreign banks in the total assets is merely 7%. This would ensure that the current regulatory regime for the financial sector, under the purview of the RBI and SEBI are not superseded by CECA.

The India-Singapore CECA is a trailblazer for India as the government is planning to sign similar economic cooperation agreements with other countries soon. Under the CECA, the bilateral commitments made by India for financial services are within the scope of GATS agreement under WTO. This also addresses the concern of the RBI that the country should not allow de facto capital account convertibility by opening up the window for financial services too wide.

The CECA with Singapore is designed to offer an integrated package governing trade in goods and services, an agreement on investment, mutual recognition agreement in services and cooperation agreement in areas such as education, e-commerce, media and intellectual property.

The CECA will take effect from August 1, 2005.

Under the CECA India's offer contains four lists:

1. the early harvest programme where customs duty will be eliminated immediately on the entry into force of the CECA on 506 lines;
2. the phased elimination of 2,202 lines;
3. the phased reduction of 2,407 lines where the tariffs would be eliminated/reduced till 2009;
4. negative list of 6,551 tariff lines where no concessions have been offered.

In all, trade in goods will entail exchange of tariff concessions under the eight digit harmonized system code covering 11,666 lines. But in the 506 items for the EHP, mostly IT products, which enjoy zero duty entry under the WTO IT Agreement, are there, apart from some commodities that dominate the two-way trade.

Singapore has offered all products made in India entry at zero duty in Singapore. Singapore is a known trading hub. Hence the CECA would be helpful in fostering supply chains from India.

On investment side, expectations are that FII investment from Singapore will rise to USD 5 billion with the implementation of the CECA in the very first fiscal year. FII investment in India's infrastructure sector will add another USD 2 billion.

GLOBAL LEADERSHIP

Reference is invited to the Vision of the Institute of Company Secretaries of India adopted in its Vision Plan 2010. Taking a position as a global leader by the profession of company secretaries in corporate governance calls for a mastery on the mechanisms and working of international capital markets that provide finance to the corporate sector. International finance is a subject that continues to develop faster as compared to the other subjects under Economics. International monetary system also became evermore unstable because of the severing of the link between commodity production and liquidity creation. Today the degree of international financial integration has increased enormously. The impact of cross-border flows of money and capital to economies that are moving away from central planning and to OECD and developing countries has increased complexities of international finance. The value of daily foreign exchange trading is more than hundreds of times of the value of annual international trade in goods and services. The pace of innovations that are taking place in the theory, policy, institutions of international finance is mind-boggling. Vast amount of empirical research is being developed and published in this field. The pundits explain new findings in the general equilibrium theory of exchange rate determination; relative immobility of long-term capital vis-à-vis highly mobile short-term capital; the behaviour of exchange rates within an exchange rate fluctuation band ["target zone"].

This is a Theme Paper drawn with this background. It seeks to expound some of the theoretical and pragmatic ground for international financial transactions and risks to enable company secretaries to approach such matters with informed abilities. The objective is only to give a working familiarity with the theoretical and market behaviour issues that are involved in international financial transactions.

FINANCE FUNDAMENTALS

Raising and managing funds from the international capital markets require a working knowledge of some financial fundamentals. Prominent amongst these are mentioned below.

It becomes necessary to understand why real exchange rates wander away for long periods from purchasing power parity and disturb real economic activity and how misinformed speculation and speculative bubbles cause floating exchange rates to be unstable and largely unpredictable. We also need to understand how best to reform the international monetary system.

The basic tools, exchange rates and balance of payment theory, still remain, as they have been to understand international finance, although complexities are on the rise. The said tools continue to be applied to a number of issues including money and macroeconomics in an open economy; the efficiency or inefficiency of foreign exchange markets; the modeling and measuring of short and long term capital flows; international macroeconomic policy coordination; international financial features of economic and financial reform in both transitional and developing economies; the economics of monetary union, the functioning of international financial institutions, etc.

MONETARY AND FISCAL POLICIES

Opening an economy to international trade and capital flows changes the nature of constraints on policy makers. Depending upon whether exchange rates are pegged or floating, the effectiveness of monetary or fiscal policy gets compromised as an instrument of macroeconomic policy.

International economic cooperation results in gain to cooperating countries because of macroeconomic spillover effects of such cooperation. In the case of monetary unions, fiscal policy externalities between member-countries of the union can be managed to the benefits of the union as a whole. In the context of a monetary union, fiscal policy is known as “fiscal federalism.” The functions of fiscal federalism remain the same as those of fiscal policy, viz, allocation, distribution and stabilization. Stabilization function is better performed or at least coordinated from the federal level. A change in a country’s fiscal stance may create externalities for other members of the union. *Ceteris paribus* [i.e. all other things remaining equal], an expansionary fiscal policy by nation “A” may yield an external benefit by stimulating growth and employment or an external diseconomy by increasing inflationary pressures in the union as a whole. These externalities are not internalized by nation “A”; it is therefore not driven to adopt, from the point of view of the monetary union, the socially optimal fiscal stance. How then to achieve the most desirable aggregated balance of national fiscal policies becomes a moot question. The union may actually require, for its overall well-being, dis-inflationary fiscal policies that are economically and politically most costly. If they do not find adoption, the sum of dis-inflationary fiscal policies would be insufficient, or the burden of adjustment would fall heavily on a few countries, e.g. those in the weakest financial position.

An international welfare gain results from international policy coordination.

Purchasing Power Parity

The purchasing power parity theory plays a central role in the determination of exchange rate and of the balance of payments. The monetary approach to the balance of payments gives us an understanding of the causes and persistence of balance of payments deficits. It holds that the balance of payments is a monetary phenomenon and not a real phenomenon. BOP should be analyzed using the familiar tools of monetary analysis, namely, the demand for and supply of money. The disequilibrium in the BOP is the reflection of the disequilibrium in money markets. The monetary approach teaches us that a devaluation can have only a transitory impact on the BOP; a growing country will hold a BOP surplus; a country can run only a BOP deficit until it runs out of foreign exchange reserves; import quotas, tariffs, exchange restrictions and other interferences to international trade can have only transitory effect on the BOP; with pegged exchange rates a country cannot run an independent monetary policy; and a rise in domestic interest rates will result in a BOP deficit.

Exchange Rates

Understanding of the mechanisms of exchange rates is no doubt crucial. Following few paragraphs deal with the related phenomena.

Predictability of exchange rates is important because many economic decisions require knowledge about future exchange rates, especially, long term real investment in traded goods sectors. The unpredictability of exchange rates and the deviation of real exchange rates from the level that balances the current account may increase if rational speculative bubbles occur. A bubble can push the nominal exchange rate far away from purchasing power parity. The monetary approach to balance of payments also shows how foreign exchange reserves shall eventually be exhausted if the rate of domestic credit expansion is excessive.

We also need to examine exchange rate behaviour in a target zone [i.e. a pegged rate fluctuation band]. Within the zone, the exchange rate may float, being determined by fundamentals; but at its edges intervention may be necessary so that foreign exchange reserves may change.

“Dirty floating” is explained by exchange rate pressure model. This model indicates how, in an environment of floating, a government may use foreign exchange reserves to nudge the exchange rate in the preferred direction

Understanding the volatility in exchange rates is a key requirement in modern international finance. The view is that foreign exchange is an asset. That is priced in an asset market [rather than in the same manner as stocks or bonds]. An exchange rate is the price of one asset [currency] in terms of another. **It is also necessary to understand that the reallocation of currency portfolios by international transactors—such as multinational corporations—affects the exchange rate. That, as a result, the stability of the international monetary system in an era of highly liquid international money flows is also affected by multinational corporations.**

International finance requires us to study general equilibrium monetary approach to the exchange rate and exchange rate regime volatility; currency crises and speculative attack; target zones and dirty floating.

Dissecting Crises

International financial system has been going through crisis after crisis. It is necessary to have knowledge of such crises in order to safeguard one's interests while operating in international financial markets. As Karl Kaiser, John J Kirton and Joseph P Daniels say in their edit role of "Shaping a New International Financial System—Challenges of Governance in a Globalizing World", Ashgate, the G-8 and Global Governance Series, a core issue concerns the causes of the crisis and contagion and whether it has now been finally concluded. Second core issue is how and how well the international community has coped with the challenges of crisis response and systems strengthening thus far. Is the challenging one of calling for incremental reform, deeper reconstruction, or historic replacement with a very new system of principles, practices, processes, and assets of institutions?

Another core issue focuses on critical defects of the old system and the best design for the new mechanisms to be added in response. We need the best weighting and mix of mechanisms for:

- transparency
- surveillance
- precautionary lending
- international standstill or bankruptcy procedures.

We need to choose the best forms, procedures and sequence of introduction and use for each and we do need to keep on bettering these. We may have to consider moving into broader domains such as control of international financial flows and capital flows, greater

exchange rate management, fixity, or even currency unification, and the rules for international liberalization or foreign direct investment.

G7 HEGEMONY

We have seen efforts during the last quarter of the 20th century to reform the international financial system, the role of the G7 in this effort. As we know, history repeats itself [due to our own ignorance and inaction] and hence we must be aware of the recent financial history as well. The world and the G7 confronted as a central challenge the task of altering in basic ways a financial system under severe stress. There was the crisis over the global exchange rate regime that served as very *raison d'être* for the birth of the G7 Summit as an economic institution – the breakdown of the Bretton Woods System of fixed exchange rates in 1971, the failure of the IMF and existing processes to construct a durable, widely accepted alternative and the decisions of the first Summit at Rambouillet, France in 1975 to institute a new system of managed floating. The second was the commercial bank debt crisis precipitated by Mexico's *de facto* default at the IMF meetings in Toronto in 1982, and the work of G7 summits from Versailles in 1982 to Paris in 1989 to arrive finally, in the form of the Brady Plan, at a solution. The third episode, debt relief for the world's poorest countries, began with the "Toronto terms" for relief at the 1998 Summit and continued through to the Cologne debt initiative of 1999.

In his analysis of the "Asian Crisis and its Implications", Takashi Kiuchi [p.37 of Shaping a "New International Financial Systems", referred earlier] locates the ultimate causes of the crisis in capital account rather than current account problems, liquidity rather than solvency problems, and the herding behaviour of the investors. He also notes how politicians overriding their officials and regulators compounded the problem. He calls for universal guidelines and processes for accounting disclosure, bankruptcy and financial supervision. Japan's response to the Asian crisis came initially in the form of a proposal for an Asian Monetary Fund that was abandoned in the face of US opposition, then with a "New Miyazawa Initiative" of US \$ 30 billion worth of bilateral lending guarantees, proposals to reform IMF and new measures to make the yen an international currency. According to Kiuchi, the crisis taught us the need for decisive action at the early stages, for enhancing the IMF's authority to deal with capital account problems, and closer regional policy coordination, beginning with macro economic policy and the development of an Asian bond market to replace

short-term borrowing from distant bankers. He approves of short term capital restrictions as a transitional measure, mandatory private sector burden sharing and state bankruptcy codes. Above all, he identifies the role of the G7 in moving towards a de facto target zone mechanism and points to the benefits that further move in this direction could bring. During times of crisis, panicked investors do not distinguish one nation from another in a region. In other words, professional fund managers cannot guide end-investors properly once liberalized financial markets enable far wider participation by amateur investors in speculative emerging markets. Nations within the region have a common stake in preserving investors' confidence. Therefore, the time is ripe for closer regional policy coordination, a process that could begin with the task of macroeconomic policy consultation. Global efforts in this direction deserve further exploration. **G7 surveillance and coordination, Kiuchi concludes, should thus be continued, sovereignty over macroeconomic policy has to be compromised considerably in an age of a globalised financial market.**

Now, what does the exclusive organisation G7 do for the Newly Industrialized Economies" (NIE's) or in other words, the developing economies of the world? Durican Wood [in his Paper "The G7, International Finance and Developing Countries" presented at Bonn on June 14, 1999, immediately after the meeting of G7 Finance Ministers in Frankfurt, and immediately before the opening of the G7 and G8 Summits themselves in Cologne on 18th June] deals with the issue as follows:

G7 has been an exclusive institution since its inception in 1975. It is an organ representing the interests and policy goals of the seven largest economies in the world. It has a country-club like exclusivity to which those left on the outside can only aspire. The G7 has indeed thrived on such a narrow basis for mutual decision-making! The identification of common interests has been relatively simple, given the similarities of economic development and political systems and the high level of interdependence among its members' economies.

In the 1970's, the exclusive nature of the G7 reflected the dominance of seven states over the global economic system. The same period witnessed a rise in LDC activism with calls for a New International Economic Order (NIEO). By the 1990s, the rise to prominence of several developing country economies, shifts in world trade and competitiveness and the increasing vulnerability of the global financial system and the separation of the G7 from the developing world, in

particular from the large emerging markets created, an anachronism.

Witnessing the trebling of the NIE's share of world trade since 1960, the 1988 Toronto G7 Summit concluded that such countries should match their increased economic importance with greater international responsibilities and a strong mutual interest in improved constructive dialogue and cooperative efforts in the near terms between the industrialized countries and the Asian NIEs, as well as other outward-oriented countries in the region.

From the 1996 Lyon Summit, G7 forwarded the ideal of a new global partnership for development focusing on cooperation, burden sharing, and partnership, of a spirit of common purpose and efficiency.

Such cooperation, however, never materialized. The G7, even taking into account its inclusion of Russia continues to be an exclusive club of the rich. Instead, the G7 has attempted to move into the new millennium without the involvement of the largest developing economies. This threatens to pose a serious problem for the Institutions in terms of its effectiveness and its legitimacy as an organ of global governance.

LDC CONCERNS

The two main areas of interest from an LDC perspective concerned the IMF's Contingent Credit Line (CCL) and "bailing in" the private sector in crisis resolution. The CCL was hailed by the G7 Finance Ministers as playing "an important part in crisis prevention". Its goal is to provide a line of credit to countries following sound macroeconomic and structural policies and with reasonable debt structures so that they are protected from contagion during currency and financial crisis. While this seems a positive form of assistance, in the view of some it actually threatens financial stability by encouraging moral hazard. The argument is simple: if a country following sound policies knows it has access to the CCL, the danger exists that it will be tempted to adopt more risky practices in the knowledge that a bail-out is already available.

As regards aid to developing countries, Lord Baur reminds, a half-century of aid has been an almost unmitigated disaster. Its politics and psychology are utterly corrupting. It has weaned large, arbitrary and corrupt governments, while crowding out individual economic freedom. A large and sudden increase in aid is a bad idea. It will overwhelm the supply capacities of weak and dysfunctional governments. For all the talk of the good governance criteria, it is bound to provide more

incentives for bigger, wasteful, corrupt and intrusive government. Underlying aid initiatives, is a world-view that David Henderson, the former chief economist of the OECD, calls Global Salvationism, or Deliverance From Above. It afflicts those who call for stronger global governance.

In reforming the international financial architecture a major initiative came from the US. The creation of the G22 in 1998 as an ad hoc grouping of developed and developing states constituted an attempt to pull together the highly varied experiences of national policy makers. This attached importance to incorporating LDC's into the international financial reform. The G22 formed three working groups that examined the issues of international financial crises, strengthening financial systems, transparency and accountability. Each working group was co-chaired by officials from one developed country and one developing country. Despite this cooperative atmosphere, the G22 did not survive long enough to make a significant contribution to either international financial architecture reform or longer term LD – G7 cooperation. The group was dissolved after it had published its reports, with the US deciding that it had served its purpose.

Since 1995, one of the central issues for International Financial Institutions has been increasing transparency and disclosure of information, in particular from LDC governments. The IMF's annual Article IV consultations, developing a core set of accounting standards, and ensuring that private sector firms engage in transparent practices.

But data gathering, says Durican Wood, and transparency, are difficult to achieve in LDCs. Many DC governments have a very real interest (usually political) in preventing the truth about their economies from being known. It is difficult to develop standards that are suitable for such widely varying financial systems as, for example, the US and Mexico. Developing standards is one thing, implementing them is yet another.

The overwhelming liberal bias amongst G7 countries and in the IMF's management is pushing them towards the realisation of a classical liberal assumption: that a market will work perfectly under conditions of perfect information. Whether or not the assumption can ever be realized, or even if it is a correct assumption, remains to be seen. And in spite of all this reality, the CII ventures to assume well-functioning capital markets.

NEW PERSPECTIVES

It has been India's traditional wont at annual IMF-

World Bank meetings to advocate substantial Special Drawing Rights [SDRs] allocation along with other developing countries. India had made some proposals to increase the amount and the use of SDRs, but to no avail. India's first proposal in the 1970's, writes Mr A Vasudevan, a former Executive Director of the RBI in the Hindu Business Line of September 16, 2004, did not get any support. In 1986, India's Executive Director proposed that industrialised countries allocate their SDRs for purposes of development in the form of an overdraft facility with a condition that the reallocated SDRs should be returned by the users to the creditors within three years. In 1999, a senior Indian official proposed that the Articles of Agreement be amended to allow the IMF to issue SDRs to itself for use in the lender-of-the-resort operations, subject to a cumulative limit on the total volume of SDRs that the IMF could create for this purpose. But now the global liquidity is sufficient and international markets are active. Hence India should not support proposals for SDR allocation or distribution.

It is also suggested that India should not go with the developing countries' position that industrialized countries should fulfil the UN target of foreign aid of 0.7 per cent of their GNP. The arguments for the increase of aid have become weak, mainly in view of the explosive expansion of private capital markets and the weak fiscal positions of many industrialized countries.

It is suggested that India should encourage movement towards economic convergence in terms of real per capita income among nations. This will reduce the relative economic distance amongst groups of nations. Countries should not be grouped in the conventional manner as industrialized economies and developing economies, but as Industrialised Economies; Emerging Market Economies; Transition Economies not categorized as EMEs; and the Rest Of the Economies. Goldman Sachs have projected that Brazil, Russia, India and China together would overtake six major IEs by 2039 going by their economy size, demographic distribution and patterns of global demand, appreciation of the exchange rates of their currencies, implementation of sound economic policies and existence of supportive institutions. Convergence requires economic cooperation, including technical, financial, technological assistance, to equitably share international economic prosperity. Financial assistance need not be in the form of loans or grants but could well be in terms of debt reduction or swaps for debts or access to domestic markets. India also needs to take initiatives as to how to utilize without delay the contingent credit lines at the IMF. She also needs to

thwart the efforts that are currently afoot to allow crisis-hit countries to have access to the IMF resources only if their past record is considered appropriate. The basis for the country's use of the IMF resources should rest on the soundness of adjustment programmes and commitments to undertake institutional reforms. Convergence leads to balanced expansion of international trade.

INTERNATIONAL BANKING

Moving your corporate in international financial circles also requires an understanding of how do banks behave in the context of the cross-border fund operations.

Following is an example of how banks form the habit of overwhelming overbidding in response to appeal by a Central Bank.

During the period January 1999 to June 2000 the European Central Bank conducted fixed rate tenders. Mr Juan Ayuso and Rafael Repullo in their Paper "Why Did the Banks Overbid? An Empirical Model of The Fixed Rate Tenders of the European Central Bank" [published by Banco de Espana—Servicio de Estudios] test two hypotheses for the overbidding behaviour of the banks in the fixed rate tenders. One hypothesis attributes the overbidding to the expectations of a future tightening of monetary policy, while the other attributes it to the liquidity allotment decisions of the ECB.

The monetary policy instruments used by the ECB are—(i) minimum required reserves, (ii) open market operations, and (iii) standing facilities. The minimum reserves help to ensure that the euro area banking system has an aggregate liquidity deficit which is covered by two main types of open market operations [selling of securities to mop up excess liquidity and buying of securities to release more liquidity in the system] and the longer term refinancing operations. The refinancing operations can be conducted via fixed rate or variable rate tenders. In fixed rate tenders, the ECB announces the interest rate and the banks bid the amount of liquidity they borrow at this rate. If the aggregate amount of bid exceeds the amount of liquidity the ECB can provide, each bank receives a pro rata share of this liquidity. In variable rate tenders the banks bid the amount they want to borrow and the interest rates they are willing to pay. In this case, bids with successively lower interest rates are accepted until the total liquidity to be allotted is exhausted.

From the beginning of the Monetary Union in January 1999 until June 2000 the main refinancing operations

were conducted as fixed rate tenders. A striking feature of these tenders was a very high degree of overbidding by the banks. During May and June 2000 the banks were bidding on average an amount that was more than eight times the size of the consolidated balance sheet of the Eurosystem.

The authors of the Paper tested two hypotheses as pointed above to explain the overbidding behaviour by the banks in the fixed rate tenders. The expectations hypothesis attributes overbidding to the expectations of a future tightening of monetary policy that led the banks to increase their current demand for liquidity in order to reduce the cost of holding reserves over the maintenance period of the reserve requirement. On the other hand, the tight liquidity hypothesis explains the overbidding by the fact that the ECB kept interbank rates over the tender rate, which generated a profit opportunity for the banks that was increasing with the quantity bid.

"Our empirical analysis" the authors explain, "uses two interest rate spreads as explanatory variables: the spread between the one-week Euribor, and the tender rate and the spread between the one-month Euribor and the tender rate. The results show that once we control for the first spread, the effect of the second is small and statistically not different from zero. Hence the evidence supports the view that the reluctance of the ECB to let the interbank rates fall below the tender rate played a crucial role in explaining why the banks overbid.

"The main policy implication of our results is the following. To the extent that overbidding is considered to be a problem, the ECB should decide the quantity allotted in fixed rate tenders in order to keep the one-week Euribor rate close to the tender rate, instead of computing the allotments from the analysis of the behaviour of the autonomous liquidity creation and absorption factors. However, in the presence of expectations of interest rate changes this alternative policy would probably introduce large variability in the sequence of allotments, which may also be regarded as undesirable."

SECURITISATION

Securitisation is a financing option that involves cherry-picking assets from the seller's book, building in adequate credit enhancements and then selling them off to a Special Purpose Vehicle or Trust. The SPV or the Trust then issues debt instruments on the strength of the underlying assets utilizing the credit rating to obtain competitive market price. As a financial tool, it has been

used to finance further assets by analyzing/scrutinizing the past assets. The company raises money by issuing debt securities, which are backed by specific asset pool. The assets are the loans, auto loans, future receivables, etc. The cash flow from the underlying assets is the source of funds for the issuer to make payments on the securities. When compared with the traditional secured debts, securitisation provides lenders/investors with greater protection against the credit risk of borrower/issuer.

In a securitisation transaction, lender/investor is like a 'super-secured creditor' with rights that surpass those of a secured lender. The subject assets are as if 'sold' by the borrower/issuer to the lender. Therefore the assets do not get entangled with bankruptcy. Bankruptcy court will not characterize the assets as merely pledged to secure a loan. To securitize, the borrower/issuer transfers the subject assets to a SPV/Trust to constitute a true sale. Then the SPV/Trust issues securities backed by those assets. It uses the sale proceeds of the securities to pay the borrower/issuer for the assets.

Banks or finance companies may use securitisation to improve the volume of funds for capital deficient sectors by transferring resources from surplus sectors. They many also use securitisation to take some customers' loans off balance sheet in order to be able to lend new funds to those customers and still maintain internal credit limits.

A company can diversify its funding resources reducing its dependence on bank loans, corporate bonds and commercial paper by resorting to securitisation. It can improve liquidity. Further, securitisation can be deployed by a company to place its securitised assets beyond the reach of the bankruptcy system. The securitised assets are excluded from the bankruptcy estate of the company that has filed for bankruptcy protection. Securitisation investors are regarded as a special class creditors who can satisfy their claims even without going to bankruptcy court although this is a controversial issue as this causes injustice to other creditors of the company and there is no provision to that effect in the bankruptcy code.

Global Funds

Hindu Business Line of August 22, 2004 reports about feeder funds that may be the next big thing for Indian investors looking for opportunities abroad. The Chairman AMFI is strongly pushing the idea, supported by a few local players of the Mutual Funds industry. The players have already expressed willingness to explore the possibility of developing the right products. Feeder

funds will be structured in the domestic market and domiciled in India. Feeder funds will be instrumental in channeling retail investments in to overseas funds. The Indian Union Government had recently opened up the retail investment limit in overseas market to the tune of \$ 25,000. Feeder funds will tap these resources and route retail investments in overseas markets. These funds will take exposure to other investment products, subject to prescribed limits. Feeder funds will whet the appetite of investors who are keen to check out newer, smarter options.. The first is a vehicle, managed by Franklin Templeton, which invests in a US fund dedicated to government securities. The second is an equity fund, offered by IDBI Principal that invests in European, Japanese and US stocks.

It is essential to address the challenge to raise the Indian savings rate from 23-24 per cent to 28-30 per cent range to sustain seven-eight per cent growth rate. Mutual Funds is the way for doing this. The returns from the traditional products provided by banks and post offices have reduced considerably. At the same time, in India, only 6.7 per cent of households own mutual funds as compared to the US where over 49.6 per cent households own mutual funds. In UK around 17 per cent of households own mutual funds. Unless performance of mutual funds becomes more stable and popular and easy-to-understand mutual fund products are made available to rural and retail households, raising of savings rate in India may not be possible. Company Secretaries need to devise strategies for advising mutual funds in India to do this so that efficiencies in the financial sector in India rise to enable Indian corporates meet the competition from MNC giants.

India, however, is yet to have real estate and commodity funds which local players must provide in the long run.

Company Secretaries who would be rendering professional services to mutual fund industry and commodity exchanges must therefore develop skills in global finance and global financial markets in order to be able to add value to such mutual fund products. Meeting the MNC giants will also require understanding of domestic mutual funds that invest in equities of such giants from abroad.

Company secretaries need to look also at the fact that Indians, and Indian corporates pay about 1.2 per cent more for bank loans and advances than international rates because of the government controls over State-owned banking entities which raise cost of funds and inefficiencies. [Former Planning Commission Member, Mr N K Singh quoted in Hindu Business Line of

August 22, 2004]. Company Secretaries can develop skills to help in further reforms in the financial sector to enable Indian companies enhance their competitiveness in order to be able to meet the giants.

Hedge Funds

MNC finances are also propelled by hedge funds known as 'rich man's mutual funds'. Other unregistered investment pools, such as venture capital funds, private equity funds and commodity pools are also known as hedge funds. Usually, hedge funds;

- are organized as private investment partnerships or offshore investment corporations;
- use a wide variety of trading strategies involving position-taking in a range of markets;
- employ an assortment of trading techniques and instruments, often including short-selling, derivatives and leverage;
- pay performance fees to their managers; and
- have an investor base comprising wealthy individuals and institutions and relatively high individual investment limit.

Learning to use and advising on hedge fund activity at the international level is another area in which company secretaries need to nurture skills for helping corporates face global competition.

As reported in the Hindu Business Line of October 13, 2004, the participation by global hedge funds in the Indian market might finally be a very restricted one. Only those entities may be registered as fall under the regulatory framework of their country of origin. This would lead to an automatic disqualification of a large number of global hedge funds from registering with SEBI since, by their very nature, such funds are entities that are not regulated in their own countries. There is no definition of a 'hedge fund' under any law. It has been pointed out that these funds could loosely be termed as unregistered private investment partnerships, funds or pools that may invest and trade in different markets and are not subject to the regulatory requirement in their home country. The SEBI task force points out the registration dilemma arising out of the unregulated nature of the hedge funds. Under the present FII regulations, hedge funds cannot approach SEBI for registration since the norms explicitly provide that only entities regulated in their place of incorporation or origin can be registered as FIIs. On the other hand, though these funds can enter through the FII sponsored sub-account route, such an entry has to be in a

surreptitious manner. This is because, any mention of the fund having characteristic of a hedge fund automatically results in the application being withheld. The Government and SEBI have been trying to work out ways to allow foreign hedge funds to register directly with the regulator instead of through the participatory note [PN] route. PNs are offshore derivative instruments in the form of contract notes issued by registered FIIs against underlying securities to overseas investors. The PN route allows foreign funds to flow in without the actual overseas investor showing up in SEBI's regulatory radar.

Helen Avery reports in Euromoney July 2004 issue that until three years ago, high net-worth individuals were almost the sole investors in hedge funds. Their relative sophistication, risk appetite and flexibility compared with institutional counterparts resulted in an affinity with hedge funds. Now, however, high-net-worth individuals account for less than 75% of hedge fund assets and in three years time their share could be below 60%.

It is not that the wealthy are removing money from hedge funds—indeed, their inflows are increasing. Rather institutional investors such as pension funds and endowments, have steadily been introducing hedge funds to their portfolios. They now hold about 25% of the 800 billion dollar assets in the sector. It is estimated that hedge fund industry could double the assets in the next three years. Institutional investors hold an estimated \$ 40 trillion in assets under management. Even if the Institutes move just 5% allocation to hedge funds, the institutional assets in hedge funds would increase ten times over. Hedge funds managers may then desert relationships with high-net-worth individuals in favour of the large lumpsums promised by the institutions. Fewer clients with more money is a better situation to be in. Theoretically, looking at historical relationship, private banks should continue to enjoy a privileged position with hedge fund managers. But institutional money would be more stable than private clients' money. Hedge fund managers might feel more comfortable with institutional clients. .Decisions of pension funds and endowments to allocate to hedge funds are not taken lightly. Asset allocation reviews tend to take place every three years, and after pension fund decides to allocate to hedge funds, the trustees will usually have some training, receive professional advice, and then go about deciding how much they want to allocate.

There are some problems, although, in the way of institutional investors allocating funds to hedge funds. Some hedge funds open and close within six months,

and institutional investors will be too slow to react, particularly if they are not familiar with the management team. Rigid demands on track records and size will also hinder the opportunities available to them. They will face risk of being excluded from hedge funds through not investing soon after launch.

These constraints are leading some hedge fund managers to ensure that their investor base is a mix of private clients and institutional money. There are pros and cons to both so it pays to have a mix. Larger investors come with a lump sum but that can have a big effect if they were to change their allocations. The two investor bases will be attracted to different strategies. Individuals have the advantage of tailoring their investment objectives to their own risk profile, whereas institutional investors are often saddled with the worries of the downside, so are typically attracted to strategies and structures with lower volatility than individuals.

Mastering Mutual Funds

Consider that the financial press has chosen to dub 2003 as a remarkable year for the way the mask fell off the face of the American mutual fund industry {Business Standard Fund Manager, Volume VI, No1, August 2004. Regulators in America clamped down hard on leading US funds for rampant violations and unethical practices. Many heads rolled. Violators had to pay heavy penalties, apart from reimbursing common investors for the losses that accrued to them on account of dubious dealings. The American mutual funds industry has been long considered to be role model for the rest of the world. Funds around the world are now introspecting more about the way they do business and taking corrective action. Back home, one of the biggest ills plaguing the fund industry is called late trading. The deal is to offer preferential treatment to large investors by offering them back-dated Net Asset Values. The offering of the previous day's NAV is bad because, for instance, if the RBI cuts repo rates unexpectedly after close of business hours, it is almost certain that the bond markets would rally the next day. A savvy investor could, thus, negotiate with a mutual fund to accept his application at a stale NAV, so that he gets a share in profits the next day when the market surges. Even though the new applicant's money is not deployed in the markets, and hence does not earn anything consequent to the market rally, the investor gets a share in the gains. Existing investors lose to the extent that their share of gains will come down as the gain is shared by a larger number of investors. In 2003, all income funds recorded daily gains of more than 0.5 per cent. Birla Income Plus—six times, HDFC Income Fund—seven times, Templeton Income Fund

—seven times. Medium and long term gilt funds obviously exhibited at least double that figure. The cost to existing investors could have been to the tune of Rs 30 crore if about Rs 1,000 crore of assets were given the benefit of stale NAVs on six crucial days when the NAV gains had been in excess of 0.5 per cent. If one considers the fact that in 2003 the gyrations in gilt funds were sharper than in income funds, a similar amount invested in funds that gained around one per cent, the loss would be Rs 60 crore for the common investors.

One more ill that afflicts the fund industry is unfair allocation of trades. Most mutual funds do not have adequate systems and processes to ensure fair trade allocations. There are no specific regulations governing trade allocations among various trade allocation schemes, although mutual funds are required to maintain records for portfolio transactions relating to each fund scheme. It is not mandatory for funds to mention at the time of purchase or sale of a security the name of the scheme for which the purchase or sale is made. If a fund manager who is responsible to manage three fund schemes wants to place an order with a dealer to buy shares, of, say Power Finance Corporation, he can do so without mentioning the names of the schemes for which he wants to purchase. Dealers effect transactions after the investment officer or fund manager places the order. The latter enjoys the luxury of allocating trades at the end of the day. This leaves scope for manipulation. He can, for example, allocate trades in a manner profitable for the fund schemes that hold promise in terms of asset mobilization.

Mutual fund industry in India is facing crisis of confidence because of over-dependence on corporate funds for building scale. The Fixed Maturity Plans that the funds use for corporates are not made available by them to retail investors. An FMP tries to match the investment horizon of the investor with that of the fund portfolio such that all securities in the portfolio are held to maturity. Since mutual fund investments attract concessional tax rates as against direct investments in securities, these products became hot favourites among corporate investors. The product is custom made to pass the benefit of tax arbitrage to preferred customers. This continues in spite of the fact that there is over-dependence on corporate customers in India. While, in India, only 2 per cent of the households invest in mutual funds as compared to one out of every two households in the USA investing in mutual funds, the catch-the-corporate mindset of Indian mutual fund industry continues. The early strategy was that mutual funds should achieve critical mass by first tapping corporate and institutional funds, raising the required volumes in

terms of Assets Under Management and then move on to retail customers. The private sector funds therefore started wooing corporate money. Although institutional money accounts for 75 to 80 percent of some funds' assets, most funds in India are coy about admitting it. Marketing job thus has been easy. The time expended on getting Rs 1 lakh out of a retail investor is far greater than getting a few crores from an institution. There has been truth in the harsh criticism that mutual funds were indulging in unethical practices and launching schemes that benefited the institutional investors at the cost of the retail investor. Ten years after the entry of private sector mutual funds in India in 1994, industry leaders are in a mood for introspection. The industry has been a witness to a whole lot of unethical practices, including mindless incentivising of distributors, promising assured returns to poorly informed investors and, in some extreme cases, switching investments from scheme to scheme. The culture of numbers has created a rapacious relationship between AMCs and their distributors where one feeds off the other.

Regulatory efforts by SEBI have not helped improve the situation either. During 2002-03, for example, SEBI devised detailed guidelines on corporate governance practices for asset management companies. One of these was the introduction of compulsory benchmarking of a fund's performance against any chosen index. The trustees of funds were also entrusted with the responsibility of reviewing the performance of various schemes against the benchmark index. Everyone including the trustees have been brought under the insider trading regulations. Trustees have now to hold meetings at least once in two months. SEBI has also made it mandatory for the board of trustees to have two-thirds of its strength as independent directors—that is those who are not associates of the sponsors. At the operational level, AMCs have also been asked to put in place risk management systems for fund management, operations and so on.

SEBI has issued guidelines for valuing bond instruments, non-performing assets, and illiquid and unlisted securities. AMFI has mandated funds to follow uniform sector classifications making product comparisons easy for investors. SEBI has also prescribed a code of conduct for mutual fund distributors. But the onus is on fund managements to ensure that their agents and distributors follow the practices laid down in the code of conduct. Yet to hardsell a fund scheme, distributors often share a part of their distribution commission with brokers and retail investors as an incentive. This amounts to promoting and selling schemes for wrong reasons that ends up in misleading

the investor. SEBI has put the onus on the fund houses to monitor their distributors and stop incentivising investors.

Convergence between Securities and Commodities

Again, while late trading has been rampant for several years, SEBI took corrective action only recently by introducing uniform cut-off timings for equity and debt funds. It also asked AMCs to set up time stamping machines that would keep track of the date and time when applications were received to curb late trading.

Commodities markets are witnessing exponential growth. Soft interest rates and weak dollar have contributed to this. Commodity prices are soaring for crude oil, silver, soyabean, gold, corn, wheat, copper, unleaded gasoline, and natural gas. Price discovery and risk management are propelled as functions of commodity markets in their futures segment. The notional value for the OTC commodity futures market alone has reached the level of 1.5 trillion dollars.

Around mid-September 2004, a top executive of a bank in Chennai earned a little over Rs 20,000 by trading in commodity futures market in Florida—at the same time as Hurricane Ivan hit Florida. He made the money by buying December wheat contract at \$3.21 a bushel and selling it at \$3.30. The executive had invested with a US broking firm and sought a portfolio manager to take care of the investment. The amount was invested in wheat futures which is less risky. As Hurricane Ivan neared the US shores, the panic of destruction pushed the wheat market higher. It was possible to book profit on the trade. High net worth individuals such as bank executives have begun to invest in commodity futures in the US. The permission was given by Indian government to individuals to remit upto \$ 25,000 a year abroad for any purpose. Earlier, NRIs used to invest in commodity futures in Chicago and New York. Now resident Indians have also begun to invest.

To trade in commodity futures in the US one has to approach a Foreign Introducing Broker. Then a client account agreement and a risk disclosure statement have to be signed by the applicant and sent across to the US Futures Commission Merchant [FCM] for opening an account in the client's own name.

Once the account is set up, the client wires funds to his Customer Segregated Account.

No deposits are collected from the client by Foreign Introducing Brokers. They may act solely in the capacity of a portfolio manager if the client so wishes. The minimum amount to be invested is \$ 5,000 and the

client himself has control over the deposit and withdrawal of the funds. There is no lock-in period for the margin deposit. The investment is only towards the margin money for the futures contract the client enters into. Investors can also take part in options in the futures which are perceived to be less risky. To handle the investment by nominating the latter as a third party controller of the account. The brokerage charged depends on the investment made, its size and number of trades done. While nominating a portfolio manager, the client indicates the percentage of the risk that can be taken. Most of the clients start by offering a ten per cent risk. As they gain confidence, they permit the risk up to twenty per cent. In case the portfolio manager exceeds the limit of risk allowed by the client, then it is the client's discretion to withdraw his funds.

A keen investor can follow the traded prices online from various sites on the futures market.

The investment managed by the portfolio manager is fully transparent and the FCM sends statements on a daily basis to the client. The client is also free to withdraw his profits every month. With a 3 trillion dollar a day turnover a commodities market is better organized and is a mature ground for investors.

In India, after the World Bank and UNCTAD reports in 1996, futures markets in agricultural commodities were opened. Today, trading in commodities derivatives in India is restricted to futures contracts only. This has been made easier and more reliable with the introduction of exchanges with state of the art technology, prudential norms, sophisticated risk management practices, and investor friendly trading platforms. A price discovery process in the spot markets and effective hedging mechanisms and referral pricing have made it possible for traders to deal in the commodities market. People exposed to commodity price risk also have access to the market to hedge against that risk.

There is a clear **convergence** between the functioning of trading in securities markets will find several similarities in commodities futures trading. The fundamentals of trading in commodity futures are the same as those followed in the F&O segment of the equity market. As in the case of any other financial instrument, predicting price movements accurately is not possible. Trading in commodities has similar inherent risks comparable with other financial markets. It is essential that retail investors understand these risks before venturing into commodities trading.

The retail investor should first choose the

commodities exchange on which he will trade. For this purpose he will study the parameters like

- the background of the exchange;
- risk management systems;
- margining approach;
- size of settlement guarantee fund;
- liquidity of the contracts for ease of entry and exit.

Then the retail investor should approach a member of the exchange in order to access the commodities futures market. By paying a brokerage and upfront margin, one can take positions in the futures market. Retail investors can also widely trade in the commodities market through web-based trading systems. Through mutual funds also investments can be made as professional investment management service is available there. Commodity prices are influenced by global macro factors. This requires domain expertise in commodities, understanding of market dynamics and price forecasting skills. Commodity funds with qualified analysts and fund managers boost confidence of retail investors. Mutual funds have started believing that they should enter into commodities in order to diversify their portfolio and to deliver better returns. Commodities will prove an ideal portfolio diversifier as there exists a low correlation among commodity, debt and equity returns. This points to a convergence of securities and commodities markets and will usher in changes in the regulatory system. There are also certain other advantages of the commodity markets to the investors and traders. The margin required for taking a position is normally much lower than the margin on the stock markets. The margins vary between 5 to 10% on an average as compared to 20 to 30% in the equity segment. Again, unlike equity futures where the contract size for all underlying is fixed at Rs 2 lakh, commodity futures have flexible contract sizes for different commodities. Therefore the ability to leverage is much higher. This reduces the trading cost substantially.

Further the recently introduced securities transaction tax is not applicable in commodity futures trading. That gives an added incentive to retail investor to diversify investible funds to commodities from equity or debt markets. The retail investors would of course have to have an internet connection and would incur related costs apart from margins and mark to market pay out costs, as in the case of stock market futures.

Hedging through Derivatives

A derivative is commonly defined as a financial instrument whose value depends in some way on the

values of other more basic underlying securities. Examples are futures on the long Treasury bond and a call option on IBM stock. Originally, these derivatives played a secondary role in finance. They were used mainly for hedging [e.g., the short sale of a future or purchase of a put option to hedge a long position in the underlying security]. Derivatives were also used by some investment managers to enhance returns, perhaps by selling covered call options on an existing portfolio. But in early 1990's there was an explosion in the use of derivative products, especially the over-the-counter variety. [A Konichi and Ravi E Dattatrya in "The Handbook of Derivative Instruments, IRWIN Professional Publishing, 1996]. Most of the growth came from the investment community rather than the corporations, the traditional users. They trace this phenomenal growth to several factors that influenced investors. Interest rates in the United States fell to historically low levels across all maturities. Suddenly, many factors found that the returns on their fixed income portfolios were barely noticeable. The traditionally high quality, high-yield area of mortgaged backed securities was also affected severely. As mortgage lenders began to offer low-cost or no-cost refinancing, home owners began to prepay their loans at rates much higher than levels assumed by investors: junk bonds. However, astute investors are always cautious of subjecting the entire capital to credit risk in return for a few basis points of extra yield. After all, credit risk is difficult to measure and manage.

Derivatives provided an alternative. Derivative-embedded securities, called structured notes, allowed investors to achieve high yields in most foreseeable scenarios. Credit risk was replaced by market risk. In addition, investors could select their type and leverage [i.e. degree] of market risk. Most often, any risk was limited to the size of coupon received. Clearly, the technical advancement in theoretical modeling and computer implementation, and the level of comfort and confidence that dealers had in such models and systems fueled the use of such derivatives.

Hedging

Hedge is a kind of derivative instrument. The purpose of hedging contract is to guard oneself against likely future loss on account of fluctuations in the value of some asset or liability a person has.

Certain derivative instruments qualify under the definition of hedging instruments. Those that qualify will be accounted for using hedge accounting. Hedge accounting generally provides for matching the recognition of the gains and losses of the hedge instrument and the hedged asset or liability.

There are three kinds of hedges one of which is a foreign currency hedge. The foreign currency hedge and its accounting is the topic of this discussion. To ensure more clarity we go by the Statement on Financial Accounting Standards (SFAS 133) issued by American Institute of Certified Public Accountants [AICPA]. The three types of hedge are discussed to have a clear perspective. They are -

1. Fair value hedge;
2. Cash flow hedge;
3. Foreign currency hedge.

A hedge of foreign currency is exposure of

- (a) an unrecognized firm commitment,
- (b) an available-for-sale security,
- (c) a forecasted transaction, or
- (d) a net investment in a foreign operation.

If a derivative instrument does not qualify as a hedge instrument under one of the three categories shown above, then its gains or losses must be reported and recognized in current earnings.

Hedging Instruments

Two primary criteria must be met in order for a derivative instrument to qualify as a hedging instrument.

- (a) Sufficient documentation must be provided at the beginning of the process to identify at a minimum
 - (1) the objective and strategy of the hedge;
 - (2) the hedging instrument and the hedged item;
 - (3) and how the effectiveness of the hedge will be assessed on an ongoing basis.
- (b) The hedge must be highly effective throughout its life. Effectiveness is measured by analyzing the hedging instrument's (derivative instrument) ability to generate changes in fair value that offset the changes in value of the hedged instrument.

At a minimum, its effectiveness will be measured every three months and whenever earnings or financial statements are reported. A highly effective hedge is such that " the cumulative change in the value of the hedge instrument should be between 80 and 125 % of the inverse cumulative changes in the fair value of cash flows of the hedged item." SFAS 133 does not provide any specific definition for "highly effective", hence this

definition may be used as a surrogate. The method used to assess the effectiveness must be used through the hedge period and must be consistent with the approach used for managing the risk. Similar hedges should usually be assessed for effectiveness in a similar manner unless a different method can be justified. Even though a hedging item may meet the definition for being highly effective, it may not eliminate variations in reported earnings, because to the extent that a hedging item is not 100% effective, the difference in net loss or gain in each period must be reported in current earnings.

FAIR VALUE HEDGES

(a) *Specific Criteria of a fair value hedge*

The hedged item must be either all or a specific portion (e.g. a percentage, a contractual cash flow) of a recognized asset/liability or an unrecognized firm commitment. Both of these situations arise frequently in foreign currency transactions.

For example, a company may enter into a firm commitment with a foreign supplier to purchase a piece of equipment, the price of which is denominated in a foreign currency and both the delivery date and the payment date are in the future. The company may decide to hedge the commitment to pay for the equipment in foreign currency in order to protect itself from foreign currency fluctuations between the firm commitment date and the payment date. For the period between the firm commitment date and the delivery date, the company will be hedging against an unrecognized firm time commitment. For the period between the delivery date and the payment date, the company is hedging against a recognized liability.

(b) *Accounting for fair value hedge*

Current earnings will recognize gains and losses on the hedged asset and liability and on the hedging instrument.

CASH FLOW HEDGES

(a) *Specific criteria*

There are additional criteria that must be met to qualify as a cash flow hedge. The primary criterion is that the hedged asset/liability and the hedging instrument must be "linked". Linking exists if the basis (the specified rate or index) for the change in cash flows do not have to be identical, but they must meet the "highly effective" threshold.

Again, it must be considered probable, based on appropriate facts and circumstances (ie past history). In

addition, if the forecasted-hedged asset/liability is a series of transactions, they must share the same risk exposure. Purchases of a particular product from the same supplier over a period of time is, for example, sufficient.

(b) *Accounting for cash flow hedges*

For the hedging instrument,

- (1) effective portion is reported in other "comprehensive income", and
- (2) ineffective portion and/or excluded components are reported on a cumulative basis to reflect the lesser of
 - (i) the cumulative gain/loss on the derivative since the creation of the hedge, or
 - (ii) the cumulative gain or loss from the change in expected cash flow from the hedged instrument since the creation of the hedge.

The above amounts need to be adjusted to reflect any reclassification of other comprehensive income to current earnings. This will occur when three hedged asset/liability affects earnings (e.g. when hedged inventory is sold and the cost of inventory passes through to the cost of goods sold).

Comprehensive Income is an accounting concept in the US. Under Statement of Financial Accounting Concepts No 6 issued by AICPA it includes all changes in equity during the period from transactions, events and circumstances other than investments, by owners and distributions to owners.

FOREIGN CURRENCY HEDGES

When one works on exchange risk control function, he many times encounters volatility in forward premia in foreign exchange markets. Meaty part of the volatility comes from "expectations" in central bank decisions of countries occupying centrality in exchange rate determination process.

On November 5, 2001, for example, forex markets were led to expect that US Federal Reserve Chairman Mr. Alan Greenspan will announce a bolder interest rate cut for the tenth time in 2001. Forward premium—the six month forward annualized premium—on dollar ended sharply higher at 6.27 per cent that day from previous Friday's close of 5.94 per cent. The longer term—the 12 month premium ended at 6 per cent. This was a 22 basis points increase from previous close of 5.78 per cent.

The renowned news agency Reuters took a poll among 24 primary dealers of US Government securities

on Friday 2nd November. Fifteen out of those 24 primary dealers predicted the FED will cut rates by a half point on November 6.

The FED funds rate influences borrowing cost across the US economy. The predicted reduction by half point would bring the rate down to 2 per cent. This would be the lowest level of the federal funds rate (which is like our bank rate) to its lowest level in four decades.

Such a rate cut, the forward markets expected, would widen the interest rate differentials between India and U.S. That was the reason why the forward premia rose. Interest rates in India are still stronger in spite of the recent cuts in the bank rate by the Reserve Bank of India.

Such volatility in forward exchange rates makes it necessary to hedge foreign exchange transactions. It is necessary to understand the accounting of the hedging transactions after understanding their nature and reason for their existence.

Foreign currency denominated assets/liabilities that arise in the course of normal business are often hedged with offsetting forward exchange contracts. This process, in effect, creates a natural hedge. Normal accounting rules apply. The Financial Accounting Standards Board decided not to change normal accounting treatment in the implementation of SFAS133. The four foreign currency hedges under SFAS 133 are as follows :

1. *Unrecognized firm commitment*

Either a derivative instrument or a non-derivative financial instrument like a receivable in foreign currency can be designated as a hedge of an unrecognized firm commitment attributable to changes in foreign currency exchange rates. If the requirements for a fair value hedge are to be met, this hedging arrangement can be accounted for as a fair value hedge.

2. *Available-for-sale securities*

A firm commitment to purchase a trading security and several transactions related to held-to-maturity securities were, prior to SFAS133, permitted to use hedging accounting under certain conditions. Now the use of hedging accounting is eliminated. This elimination applies to both trading and held-to-maturity securities. SFAS 133 limits hedge accounting to TRANSACTIONS IN SECURITIES DESIGNATED AS AVAILABLE FOR SALE. Derivative instruments can be used to hedge debt or equity available-for sale securities. However, equity securities must need two additional criteria, viz,

- (i) They cannot be traded on an exchange denominated in investor's functional currency.
- (ii) Dividends must be denominated in the same foreign currency as is expected to be received on the sale of the security.

If the above criteria are met hedging instruments related to available for sale securities can be accounted for as fair value hedges.

3. *Foreign currency denominated forecasted transactions*

This is an exception in the permitted use of hedge accounting. Only derivative instruments can be designated as hedges of foreign currency denominated forecasted transactions. A forecasted export sale with the price denominated in a foreign currency might qualify for this type of hedge treatment. Forecasted transactions are distinguished from firm commitments because the timing and the cash flows remain uncertain. This additional complexity result in hedging instruments in foreign currency denominated forecasted transactions being accounted for as cash flow hedges. Hedge accounting is permissible for transactions between unrelated parties, and under special circumstances for inter-company transactions.

4. *Net investments in foreign operations*

Here the hedging instrument has to meet the new "effective" criterion under the SFAS 133. The change in the fair value of the hedging derivative is recorded in the other comprehensive income account in the equity section of the balance sheet.

Thus it will be seen that in case of fair value derivatives, cash flow derivatives, and foreign currency derivatives or nonderivatives the balance sheet valuation of hedging instruments is "fair value".

In the case of fair value derivatives, the recognition of gain or loss on changes in value of hedging instrument is done in current earnings. In the case of cash flow derivatives, the effective portion of the gain or loss (On changes in value of hedging instrument is treated currently as a component of other comprehensive income and reclassified to earnings in future periods) that forecasted transaction affects earnings. The ineffective portion of the gain or loss is accounted for in the current earnings.

In the case of the foreign currency instruments, where it is a foreign currency denominated firm commitment, the gain or loss on changes in value of

hedging instrument is done in current earnings. If it is available-for-sale security also the gain or loss is recognized currently in earnings. Where it is a forecasted foreign currency transaction, the treatment of the gain or loss is the same as in cash flow hedge. That is to say, -the effective portion of the gain or loss is recognized currently in other comprehensive income and reclassified to earnings in future period(s) that forecasted transaction affects earnings. The ineffective portion of the gain or loss is recognized currently in earnings.

In the case of the net investment in foreign operation, the recognition of the gain or loss on changes in value of hedging instrument in other comprehensive income as part of the cumulative transaction adjustment to the extent it is effective as a hedge.

In the case of fair value derivative instrument, recognition of the gain or loss on changes in the fair value of the hedged item is done currently in earnings. Since, in the case of cash flow hedges, as they are not associated with recognized assets or liabilities, recognition of such gain or loss does not arise.

In the case of foreign currency derivatives or nonderivatives, the recognition of gain or loss on changes in fair value of hedged item is done as follows:

Where it is a foreign currency denominated firm commitment, the gain or loss is recognized currently in earnings. If it is available-for-sale security also the gain or loss is recognized currently in earnings. For a forecasted foreign currency transaction, this gain or loss is not applicable as such assets are not associated with recognized assets or liabilities.

Forward Exchange Contracts

Foreign currency transaction gains and losses on assets and liabilities, which are denominated in a currency other than the functional currency, can be hedged if a US company enters into a forward exchange contract. The following example shows how a forward exchange contract can be used as hedge, first against a firm commitment and then, following delivery date, as a hedge against a recognized liability. The general rule for estimating the fair value of forward exchange contracts is to use the forward exchange rate for the remaining term of the contract.

The hedging as a derivative instrument will be better understood by following its accounting in the books of

account supported by the explanatory narration for each journal entry:

Example : B.S.Inc. enters into a firm commitment with D.I.,AG of Germany on October 1999, to purchase a computerized robotic system for DM 6,000,000. The system will be delivered on March 1,2000, with payment due 60 days after delivery (April 30,2000). BSI decides to hedge this foreign currency firm commitment and enters into a forward exchange contract on the firm commitment date to receive DM 6,00,000 on payment date. The applicable exchange rates are shown in the table below :

<i>Date</i>	<i>Spot rates</i>	<i>Forward rates for April 30</i>
October 1,1999	DM1 = \$.55	Dm1 = \$.57
December 31,1999	DM1 = \$.58	Dm1 = \$.59
March 1, 2000	DM1 = \$.58	Dm1 = \$.585
April 30,2000	DM1 = \$.60	

The following example separately presents both the forward contract receivable and the dollars payable liability in order to show all aspects of the forward contract. For financial reporting purposes, most companies present just the net fair value of the forward contract, which would be the difference between the current value of the forward contract receivable and the dollars payable amounts.

The transactions which reflect the forward exchange contract, the firm commitment and the acquisition of the asset and retirement of the related liability appear as follows :

<i>Forward Contract Entries</i>	<i>Hedge against firm commitment entries</i>
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(1) 10/1/99 (forward rate for 4/3/00 DM 1 = \$.57)	
Forward contract receivable 3,420,000	
Dollars payable 3,420,000	

This entry recognizes the existence of the forward exchange contract using the gross method. Under the net method, this entry would not appear at all, since the fair value of the forward contract is

<i>Forward Contract Entries</i>	<i>Hedge against firm commitment entries</i>	<i>Forward Contract Entries</i>	<i>Hedge against firm commitment entries</i>
<p>zero when the contract is initiated. The amount is calculated using the 10.1.99 forward rate for 4/30/00 (DM 6,00,000 x \$.57 = \$3,420,000). Note that the net fair value of the forward exchange contract is zero on 10/1/99 because there is an exact amount offset of the forward contract receivable with the dollars payable liability.</p>			<p>previous one. This entry reflects the first use of the firm commitment account, a temporary liability account pending the receipt of the asset against which the firm commitment has been hedged.</p>
<p>(2) 12/31/99 (forward rate for 4/30/00 DM 1 = .589) Forward contract receivable 114000</p> <p>Gain on hedge activity 114000</p> <p>The dollar values for this entry reflect, among other things, the change in the forward rate from 10/1/99 to 12/31/99. However, the actual amount recorded as gain will be determined by all market factor</p>		<p>(4) 3/1/00 (forwarded rate for 4/30/00 DM1 = \$.585) Loss on hedge activity 24,000</p> <p>Forward contract receivable 24000</p> <p>These entries again will be driven by market factors, and they are calculated the same way as entries (2) and (3). Notice that the decline in the forward rate from 12/31/99 to 3/1/00 resulted in a loss against the forward contract receivable and a gain against firm commitment.'</p>	<p>(5) 3/1/00 Firm commitment 24000</p> <p>Gain on hedge activity 24000</p>
	<p>(3) 12/31/99 Loss on hedge activity 114,000 Firm commitment 114,000</p> <p>The dollar values for this entry identical to the previous entry, reflecting the fact that the hedge is highly effective (100%) and also the fact that the market recognizes the same factors in this transaction as the</p>		<p>(6) 3/1/00 (spot rate DM 1 = .58) Equipment 3,390,000 Firm Commitment 90,000 Accounts 3,480,000</p> <p>This entry records receipt of the equipment (recorded at fair value determined on a discounted net present value basis), the elimination of the temporary liability account (firm commitment), and</p>

<i>Forward Contract Entries</i>	<i>Hedge against firm commitment entries</i>	<i>Forward Contract Entries</i>	<i>Hedge against firm commitment entries</i>
	the recognition of the payable, calculated at the spot rate on the date of receipt (DM 6,000,000 x \$.58 = \$3,480,000)	of foreign currency units valued at the spot rate (DM 6,000,000 x \$.60 = \$3600,000)	
(7) 4/30/00 (spot rate DM 1 = \$.60) Forward contract receivable 90,000 Gain on forward contract 90000 The gain on the forward contract is calculated using the change in the forward to the spot rate from 3/1/00 to 4/30/00 [(DM 6,000,000 x (\$.60-\$.585)]	(8) 4/30/00 Transaction loss 120,000 Accounts payable (DM) 120,000 The transaction loss related to accounts payable reflects only the change in spot rates and ignores the accrual of interest. DM 6000,000		In the case of using a forward exchange contract to speculate in a specific foreign currency, <u>the general rate to estimate the fair value of the forward contract is to use the forward exchange rate for the remainder of the term of the forward contract.</u>
(9) 4/30/00 Dollars payable 3420000 Cash 3420000 Foreign currency units 3,600,000 (DM) This entry reflects the settlement of the forward contract of the 10/1/99 contracted forward rate (DM 600000 x \$.57 = \$3420000 and the receipt	(10) Accounts payable 3,600,000 (DM) Foreign currency units 3,600,000 This entry reflects the use of the foreign currency units to retire the accounts payable.		

CONCLUSION

When facing a globalised professional services market growing by virtue of global or regional multi-lateralism through RTAs and CECAs apart from the WTO, Company Secretaries need to come to grips with the mechanics and operations of international financial market. The Theme Paper delineates some theoretical and practical aspects of international financial transactions and markets. It is necessary to understand the fundamentals, behavioural patterns, different financial industries working cross-border, and inter-country financial markets and transactions in order to raise funds internationally and to manage risks of cross-border activities. This Paper seeks to address these issues. Although the scope of the topics extends far beyond the counters of a single Paper's dimensions, the wide range of glimpse provided hereunder should generate basic understanding and necessary inquisitiveness that a Company Secretary specializing in corporate governance would need to keep at the back of his mind while countenancing international financial transactions for the corporate sector.

GLOBAL CONVERGENCE IN GOVERNING BANKING AND FINANCIAL SECTOR

V P SHARMA* & M A JOSEPH**

INTRODUCTION

The financial system in any economy plays an important role in promoting economic growth and development by improving the efficiency of resource mobilization, pooling of savings and allocating these savings to investment outlets. It provides both liquidity and capital to firms in their production processes or services and facilitates a reliable payment system, thereby providing a veritable platform for an effective monetary policy management. For a financial system to achieve these objectives, it must be developed through the collaborative efforts of the government, the monetary authorities, the financial institutions, the regulators and the general public. The monetary authorities must therefore improve on their supervisory processes and pursue policies and standards that would enhance the safety, soundness and efficiency of the financial system in a country.

Financial institutions including banks, the major operators in the financial system, provide the institutional mechanism for financial intermediation in the system by managing the financial assets and liabilities of other economic units. They mobilize deposits, provide credits and in the process create money, offer professional advice to investors and act as agents of the government in the implementation of various monetary and macroeconomic policies.

Given the overall importance of banks in the economy, their supervision, control and regulation become imperative for ensuring a stable and healthy financial system. Supervision and controls entail, not only the enforcement of rules and regulations, but also some judgment regarding the quality of financial institutions' assets, capital adequacy and management, while regulation involves the specific rules governing expected behaviors that limit or control the activities and operations of financial institutions. Often, these

concepts are used interchangeably because of their close associations.

Banking Supervision, as part of public infrastructure, has the major role in ensuring financial sector stability and sustainable economic growth and development. Effective economic policy management requires a robust, efficient and sound financial sector. Supervisors must therefore ensure that banks and other financial institutions are operated in a safe and effective manner that would guarantee sustainable economic growth. Instability and poor performance in the banking sector could lead to bank failures, loss of public confidence as well as adverse macroeconomic environment with negative impact on real incomes, employment and output.

Banks' capital is only a small part of their sources of funds, the major source of their funding being deposits from investors. Hence, depositors need protection, primarily because they do not have the means to determine the extent of risks taken by banks in using of their money. The supervisory and regulatory framework must ensure that banks operate within the prescribed prudential limits and standards, in a safe manner which uphold high standards of professional conduct that would sustain continuing confidence in the banking system.

As a result of the growing volume of international trade, financial institutions have adopted more effective and efficient ways to facilitate and finance cross border transactions and at the same time manage the related risks. The resultant close linkage between financial institutions and financial markets has in turn necessitated, among other things the development of financial derivatives, strong support for reducing counter party credit risk and a growing need to clarify laws and regulations regarding cross-border financial contracts. Supervisors in financial institutions/banks world over, have consequently realized and recognized the need to

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harmonize laws, regulations, codes and standards in order to promote economic growth and international financial security and stability. This has created the need of convergence of regulatory bodies, institutions etc. with reference to financial market in order to achieve the optimum results in global competitive environment.

At present, financial markets are globally in transition. Traditional business models, when businesses were clearly differentiated (Banks conduct banking, insurance companies offer risk covers and securities companies offer investment opportunities), have become the footnotes of the finance literature. Nowadays, insurance companies are exploring opportunities in the banking and investment products and *vice versa*. It is no more a bank competing with another bank and insurance company competing with another insurance company, but insurance companies competing with banks and banking companies stand against insurance companies. Hence, the most talked about word today is the **“convergence”** of the opportunity zones in financial markets from concept to culmination.

Regulatory convergence in this context refers to the process by which regulators of a nation's financial institutions establish common principles and homogenous norms to be followed by all supervised financial intermediaries, such as commercial banks, insurance companies, and securities firms, among others. The principal aim of regulatory convergence goes beyond ensuring the soundness of individual intermediaries and sectors of the financial industry, for securing overall financial system stability in a country. Structuring of financial supervisory systems to meet this objective also serves to enhance protection of depositors, investors and policyholders and to support economic stability and viability.

Regulatory convergence may be viewed as a direct response to the convergence in the products and services offered by the different types of financial intermediaries. It has been observed that the competitive dynamics of market has changed phenomenally. Nowadays, market players compete in one segment and co-operate in other segment. Strategic alliance of the competing banks on the ATM infrastructure is a live example. Today, mutual funds also compete with the banks on deposits, as they too provide liquidity and cheque facility with certain limitations. Revolutionary waves have gone to the extent of providing the ATM facility to even the mutual funds investors. It is very interesting to observe the competition mounting across the opportunity zones because that encourages institutions to improve and deliver better values to the market leading to growth of overall productivity of the nation.

As stated earlier insurance products are other examples. One would observe that the buyer of the insurance products also looks at them as the investment products. This is an issue conditioning over the period of time and therefore, the buyers of the insurance products are both the customers of the risk protection and the investment products. This leads to the insurance sector competing with the other avenues of the investment including banks, financial institutions and investment companies. The structure of the players in different opportunity zones is also changing on continuous basis. Corporate marriages, exchange's mergers, clearing corporation's alliances, regulator's integration, etc. at global level bear testimony to it. Convergence of the financial products is also apparent, everywhere.

On regulators side, deeper co-ordination has become the need of the hour. Creation of the Financial Services Authority by merger of all the regulators in U.K. has set a precedent in itself. Now, a number of countries, across the globe, are thinking on these lines. Recently, Germany has joined the U.K. through creation of the Financial Services Supervisor, a combined regulatory authority for the banking, securities and insurance. The logic behind is simple – integration of the opportunities zone demands a flexible, efficient and effective supervisory regime. This can be accomplished either through the effective co-ordination among the regulators or the creation of single regulatory body. Some economies are choosing the former and others the later.

MANIFESTATION AND CHALLENGES OF MARKET CONVERGENCE

Market convergence arises from the increased blurring of the lines of demarcation between different types of financial institutions and the various products they offer to the customers and the resulting increase in competition for market share and survival. One impact of this competition has been disinter-mediation, where companies that don't operate as banking licensees, structure products which result in traditional banking products such as loans, being effected through non-banking means. An illustration was the introduction of commercial paper, which saw deposits actually carving out of the system. Similar banking products are being offered by non-banking entities. For example:

- Deposit-like products marketed by insurance companies which have “just a little insurance”;
- Products being offered by securities houses which not only allow clients to invest in securities but also allow access to funds,

through cheque facilities owned and operated by the securities as in the case of commercial banks.

These types of products greatly resemble deposits and have given some concern to the Bank Supervisor/regulators. This highlights the need for recognition that although not truly deposits, such activities must take place under similar prudential requirements as for deposit-taking entities.

Another impact of this competitive pressure has been the formation and increasing dominance of diversified financial group-conglomerates – that provide a range of financial services across traditional jurisdictions. These cross-sector groups carry a unique risk profile, which relates to the following:

- *Contagion* whereby financial problems are transmitted from one group member to another. Here, one entity within a group can be at risk of a loss of confidence arising from negative publicity about the activities of a fellow group member or affiliate. This may also result in one group entity being drawn into the adverse circumstances of a problem of an affiliate if it is pressured by the group's management to offer liquidity and other support to that affiliate.
- *Conflicts of interest* where decisions taken by the management of a financial group to benefit the group as a whole, may not be in the best interest of a particular entity or the specific group entity which is charged with carrying out the activity leading from the decision.
- *Complex and opaque corporate structures*, which may obscure the real governance and management structure of a financial institution that forms part of a group. This may also complicate the assessment of the group's and the individual institutions' true risk profile and the adequacy of their capital, which specifies the ground conditions for the unhealthy phenomenon better known as regulatory arbitrage.

The resulting challenges to the different authorities that regulate and supervise financial institutions and conglomerates include the following :

- Similar activities across financial sectors are often treated inconsistently due to differential prudential requirements of the varying Supervisors. This encourages migration of activities from areas where there is stringent

prudential requirement to other sectors where the market has assessed as being less rigorously regulated and with less prudential requirements to meet for essentially the same activity. This can again lead to regulatory arbitrage that thwarts the intent of regulation.

- Blurring of supervisory responsibilities, which may result in overlap, conflicts and even supervisory gaps as between banking, insurance, securities and other financial sector supervisors.
- Obscuring of the limits of deposit protection, which *de facto* results in public perception of an increase in the government safety net across broad classes of financial sector liabilities;
- The need to quickly respond to the anomalies in regulation and supervision in an environment that includes complex and diverse organizations while continuing to pursue the objective of promoting financial stability.

Regulatory convergence therefore is directed to address these challenges, in a situation where financial sector regulators, must continuously evaluate the effectiveness of the regulatory framework, in light of the dynamic nature of financial markets.

INSTITUTING REGULATORY CONVERGENCE

Regulatory convergence may be instituted through any of the following or the both basic supervisory structures :

- Institutional convergence, which refers to the consolidation of regulatory and supervisory functions into one agency to supervise all financial sectors; banking, securities, insurance, pensions, housing societies and so on.
- Retaining specific sector regulatory agencies, while strengthening co-ordination and exchange of information between relevant agencies.

In order to ensure effective regulatory convergence the following five essentials are considered irrespective of the type of supervisory structure to be adopted :

- Firstly, streamlining of the laws and regulations governing the functioning of banks, securities firms, insurers, etc. and convergence of relevant supervisory methodology to ensure consistency in regulation and prudential standards for similar activities across different institutions.

- Secondly, close co-operation and co-ordination between financial system supervisors; whether domestically or internationally. This approach is most effective where formal agreements that codify policies and strategies to be adopted to facilitate greater co-ordination on issues such as information sharing, lead regulator and the conduct of coordinated examinations for dually supervised entities that have been established.
- The third essential is comprehensive consolidated (conglomerate) supervision that seeks to minimize potential contagion within groups, promote transparency of group structures and finances, and to promote accountability of directors and managers of individual regulated entities.
- Fourthly, effective market discipline which, after ensuring good governance and management, is the best line of defence against excessive risk taking by financial groups. In this regard, disclosure is essential for the market to be able to make decisions on an informed basis.
- And lastly, well-defined and coordinated supervisory responses and contingency plans to deal with problems which may arise in individual entities or sectors or present systemic threats.

CONVERGENCE FACTORS

In the past years, financial markets and institutions world over, have become larger, more complex and more tightly integrated. As a result of this process of convergence that has been shaping the global financial industry has been powerful and broad based. The developments have been propelled by a number of driving forces which include the following :

Deregulation and Liberalization. Deregulation involves the relaxation of controls usually designed to override market forces. Countries are rapidly shifting towards market forces and private enterprises for the management of economies. These have manifested in the steady retreat of the State from administrative and quantitative controls. Deregulation has contributed to the increasingly intense competition and the blurring of traditional distinctions between different types of financial institutions. On the other hand, liberalization, entails the removal of impediments to world-wide expansion of trade in goods and services, flows of capital and foreign investment. Liberalization has also led to the tremendous growth in the number and variety of

financial institutions, the volume and complexity of operations, as well as the number of products and services offered due to the increased competitiveness in financial intermediation.

The respective role of capital markets and of financial institutions have been converging. Markets have made major inroads as mechanisms for allocating both funds and risks within the economy that were once primarily the domain of banking institutions or other regulated financial intermediaries. Now financial markets are not only a key supplier of credit but also a provider of traditional insurance services. For instance, rapid growth of catastrophe bonds. In addition, they transfer risks across segments of the financial system, not least through derivatives. Initially, derivatives addressed market risk; now, by the unfolding revolution is an instrument to manage credit risk. Crucially, in the process, the dividing line between market-traded and non-traded financial instruments and that between insurance and other types of financial instruments that provide protection from specific risks have become increasingly blurred. Credit risk insurance can, in fact, be thought of as one such example.

Globalization : The increasing awareness of the potential advantages of opening national financial markets to international competition has led to globalization, a process of integrating national economies into a global market place in which all nations can freely participate. The process also involves the creation of harmonized trade policies, rules and practices across the globe. Globalization is increasingly fuelled by international financial institutions and regional groupings, which promote similar policies across the world. Different types of financial institutions have been converging. This has been true even as the financial landscape has become more diverse. In insurance, for instance, companies have been providing products with an increased financial component. Thus, through products such as single premium unit-linked insurance policies, insurance providers now compete directly with mutual funds. And the growth of conglomerates that encompass both insurance and banking has eroded the long-standing barriers that had kept these two lines of business apart. Financial arrangements across different national jurisdictions have been converging - a process that most of us know as "financial globalization". As obstacles to capital flows, foreign establishment and the cross-border provision of financial services have come down, resulting which the pressure to adopt similar arrangements across countries has grown. In insurance sector, for instance, cross-border ownership of companies has increased considerably.

Technology : A rapid technological change in Information Technology (IT), communication and transport has given rise to new products and services, methods of management and organization of production. Similarly, innovations in technology have provided a fresh stimulus for capital. For enterprises some forms of specialization and consolidation have made possible an entirely new and much cheaper means of delivering financial services. Additionally, it has facilitated the development of new financial instruments and investment strategies and radically changed trading mechanisms. Furthermore, technology has made it easier for both financial institutions and their regulators to measure, monitor and manage risks.

Within the framework of these driving forces, the global financial market has been subject to increasing volatility and vulnerability such that there have been currency, banking and financial crisis in some regions. Thus, the needs for fair, sound, stable and consistent policies, standards, procedures and practices have become imperative. Indeed, the global growth of financial markets and institutions have provided the impetus for cooperation, coordination and harmonization among different countries' supervisory and regulatory systems.

AREAS OF COMMON INTEREST AND INTERNATIONAL AGENCIES

There are essentially two reasons that necessitate most international efforts to coordinate banking issues: Firstly, to maintain a healthy, responsive and financially strong banking and financial system that will facilitate the growing needs of domestic economies. Secondly, to build and maintain adequate legal and regulatory structures that will permit institutions to compete safely on an equal and non-discriminatory basis, both domestically and internationally.

The promotion of sound risk management has become of common interest and the regulatory and supervisory authorities continue to build on "best" or "sound" banking practices in designing rules and regulations, working towards such a common end will be achieved. Apart from risk management, other areas of common interest in banking supervision and regulation include issues relating to accounting standards, auditing practices, corporate governance, information dissemination, transparency, cross-border securities transactions and insurance. These areas have continued to be addressed by relevant agencies across the globe.

The agencies established to address these common areas of interest include the International Accounting

Standards Board [IASB], International Federation of Accountants [IFAC], Organization for Economic Cooperation and Development [OECD], International Monetary Fund [IMF], The World Bank, United Nations Commission on International Trade Law [UNCITRAL], International Bar Association [IBA], International Association of Insurance Supervisors [IAIS], Committee on Payments and Settlements Systems [CPSS] and International Organization of Securities Commissions [IOSCO], etc.

These international agencies have issued standards, guidelines and codes along the areas of common interest to supervisory and regulatory authorities worldwide. However, in implementing the standards, guidelines and codes, supervisors are never unmindful of their environment and the structure of the financial institutions in their jurisdiction. Such consideration should however not impair their oversight responsibilities because in the global market, weak or ineffective supervision in either large/developed or small/developing countries can have adverse and far-reaching consequences. It is therefore important for supervisors to relate and cooperate with their counterparts in other countries in implementing the agreed standards for the safety and soundness of their financial institutions and the global financial system.

INTERNATIONAL STANDARDS AND CODES

International financial standards have been developed to help financial authorities for fashion prudent policies, increase transparency and improve institutional and market infrastructure. These, in turn, are expected to reinforce the stability of the international financial system. It is, therefore, in the overall self-interest of any country not only to adopt these standards but also to adhere to them as much as possible. The basic responsibility for ensuring the implementation and monitoring of the standards rests with the relevant financial sector supervisory/regulatory agencies in each country. Many proposals have been made for strengthening the international financial system. These proposals have broadly focused on the indicators of financial vulnerability, the development of sound international codes, standards and best practices, the introduction of pre-emptive measures and safety nets, and the designing of a framework for crisis management.

As part of the effort to strengthen financial systems and improve coordination among the agencies responsible for them, the Financial Stability Forum [FSF] was established in April 1999. Its mandate was to promote international financial stability by improving the functioning of markets and thereby reducing systemic risk through information exchange and international

cooperation in the supervision and surveillance of financial markets. The FSF has drawn together various standard setting bodies, which were constituted by means of cooperation among central banks, international financial institutions, national authorities and international supervisory and regulatory bodies.

The FSF has produced a compendium of standards, which serve as a common reference. Currently, there are 69 standards in the compendium. A set of 12 standards has been highlighted by the FSF as key, for sound financial systems and deserving consideration for priority implementation. These 12 key standards, which are organized under three broad headings, are accepted as representing minimum requirements for good practice as listed hereunder.

A. Macro-Economic Policy and Data Transparency:

1. Code of Good Practices on Transparency in Monetary and Financial Policies;
2. Code of Good Practices on Fiscal Transparency; and
3. Special Data Dissemination Standard.

B. Institutional and Market Infrastructure:

4. Principles and Guidelines for Effective Insolvency and Creditor Rights Systems;
5. Principles of Corporate Governance;
6. International Accounting Standards;
7. International Standards on Auditing;
8. Core Principles for Systematically Important Payment Systems; and
9. The Forty Recommendations of the Financial Action Task Force on Money Laundering.

C. Financial Regulation and Supervision:

10. Core Principles for Effective Banking Supervision;
11. Objectives and Principles of Securities Regulation and Disclosure Standards to Facilitate Cross-Border Offerings and Initial Listings by Multinational Issuers; and
12. Insurance Supervisory Principles.

Perhaps, among the above, we should focus on one of the standards that seem to be most relevant to banking supervision. The Core Principles for Effective Banking Supervision was developed by the Basle Committee on Banking Supervision to provide the international financial community with benchmarks against which the effectiveness of bank supervisory

regimes can be assessed. The need for strengthening the supervision of banks has been stressed as a major priority since it is now widely recognized that weaknesses in banking systems have been the cause of financial crisis in many countries over the last decade. Thus, the Core Principles, which have been endorsed and are being implemented by a vast majority of countries, have become the most important global standard for prudential regulation and supervision.

The Basle Core Principles comprise 25 basic principles, which are regarded as minimum standards that need to be in place for any supervisory system to be effective. They relate to 7 main areas of supervision namely: pre-condition for effective banking supervision; licensing and structure; prudential regulations and requirements; methods of on-going supervision; information requirement; formal powers of supervisors; and cross-border banking. The Basle Committee continues to take the lead in coordinating banking supervisory policies and practices globally.

Another area the Basle Committee has also excelled so much is on the setting of capital standards. Recognizing that adequate capital is essential for fostering the safety and soundness of banks, the Committee issued the first Capital Accord in 1988. Since then, it has continued to develop and refine the standard in an effort to keep pace with banking practices and to maintain adequate levels of bank capital throughout the world. From the start, it was observed that the 1988 Accord was not perfect in several respects. Although the Accord incorporated some differentiations in credit risk, it was limited. Moreover, it did not explicitly address interest rate risk, market risk, operational risk, and other risks that could be significant in some banks. In order to address the initial and inherent imperfections, the Committee in 1996, reviewed the 1988 accord to incorporate market risks in the determination of the adequacy of banks' capital. It also recently issued the New Capital Accord that is more comprehensive and risk sensitive in approach and consists of three mutually reinforcing pillars.

Pillar I is the minimum capital standard which essentially is the Existing Accord with some additional requirements. *Pillar II* is supervisory oversight of capital adequacy at individual banks while *Pillar III* is market discipline, involving adequate public disclosures by banks. The addition of Pillar II and III emphasise the importance of ongoing review by supervisors of the capital adequacy at individual banks and the critical role of market discipline in controlling risk-taking by banks.

The Committee expects the implementation of the New Accord to commence by the end of year 2006. This is to allow time for necessary amendments to the legislative framework and for effecting any changes that might be necessary in the various countries' processes, procedures and information systems. Also, time is required to build up the required data bank for the extensive statistical records that most aspects of the new package would require. Supervisors and operators would also require time for training.

The several interrelated standards and codes represent the collaborative efforts of developed countries and emerging economies, international institutions, public and private sector regulators and market participants. In addition, the current initiative provides for assessment methodologies involving external assessment and incentives for internal assessment of the degree of compliance of a country with the key standards and codes. Furthermore, the entire exercise is undertaken on the premise that its implementation would not only help to promote sound financial systems within the different countries but also would ensure smooth integration into the global market, thereby contributing to finance stability in the global system. The adoption and implementation of international standards and codes are also fostered by regional groupings in order to optimally derive the inherent benefits and also move towards a better assimilation into the global financial market.

INDIAN SCENARIO

The principles and vision of supervision in Basel II are valuable for supervisors and banks not only across the developed markets, but even the developing ones. Unique feature of the Indian financial system is the diversity of its composition. Major chunk of banking sector business goes to public sector banks. The process of providing financial services is changing very rapidly from traditional banking to a one stop shop of varied financial services and the old institutional demarcations are getting increasingly vanished.

In recent years, there has been a considerable widening and deepening of the Indian financial system, coupled with the increasing globalization of financial services. India is fast approaching to an era of financial conglomeration and 'bundling' in the provision of financial services. These developments are opportunities for the market participants but nevertheless pose serious challenges to regulation and supervision of the banking system.

In India, the pursuit of financial and macroeconomic stability has emerged as the central plank of financial

sector reforms. Stability of the financial system has a critical influence on price stability and sustained growth, which constitute the principal objectives of monetary policy. A stable financial system facilitates efficient transmission of monetary policy initiatives and the smooth operation of payment systems. From the perspective of regulation and supervision, safeguarding depositors' interest, and ensuring strong risk management within payment, clearing and settlement systems, are the mandates of the Reserve Bank of India (RBI). The RBI has put in place Prudential Supervisory Reporting System, covering all vital aspects and a wide range of indicators, which serves as an early warning signal as well. Macro-Prudential Indicators (MPIs) have been compiled since March 2000, collating data from various reports that are received in the regulatory and supervisory wings of the Bank. The review of MPIs covers the areas of capital adequacy, asset quality, risk management, management soundness, earnings and profitability, liquidity, interest rate, maturity structure of assets and liabilities, and various indicators pertaining to major segments of financial markets such as debts, forex, capital market segments, besides macroeconomic indicators such as growth, inflation, interest rate and exchange rate. The MPI review is accompanied by a review of developments in the global environment. As part of the efforts to disseminate these Financial Soundness Indicators (FSIs), the Reserve Bank of India has started publishing the core set of indicators in its various publications.

Financial sector reforms adopted in the 1990s have enhanced the strength of banks and financial institutions in India. A striking feature of these institutions has been their improved resilience to the domestic and the external environment. The reform process has changed the relationship between the RBI and commercial banks from one of micro regulation to that of macro management. Aided by the robust macroeconomic environment, banks' bottom lines have improved significantly over the last two years. The aggregate capital adequacy ratios of scheduled commercial banks stood at 12.83 per cent as at end March 2005 have been well above the stipulated level of 9 per cent.

The Reserve Bank of India along with the Government, has initiated several institutional measures to contain the levels of Non-Performing Assets (NPAs). Notable among these include establishment of Debt Recovery Tribunals, Lok Adalats (people's courts), Asset Reconstruction Companies (ARCs) and Corporate Debt Restructuring (CDR) mechanism. Settlement Advisory Committees have been formed at regional and head office level of commercial banks. Enactment of the

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 has helped in improving the recovery climate in the country. The Government amended the relevant provisions of the Act to address the concerns expressed by the Supreme Court regarding a fair deal to borrowers through an ordinance dated November 11, 2004. The declining trend in gross and net NPLs for scheduled commercial banks has continued despite the adoption of 90-days delinquency norm and unprecedented surge in growth of advances.

Legislation has since been enacted to facilitate the compilation and dissemination of credit information including data on defaults to the financial system by the Credit Information Bureau of India Ltd. (CIBIL). The legal provisions and practice in bankruptcy of the real sector are however still inadequate and need further reform.

The Reserve Bank is also making efforts to formulate policies to deal with risks arising on account of operations of large and complex financial institutions as these pose a systemic risk. As a first step in this direction, in June 2004, an inter-agency Working Group on Financial Conglomerates (FC) comprising three supervisory bodies, viz., the Reserve Bank, the Securities and Exchange Board of India and Insurance Regulatory and Development Authority, identified 23 FCs and a pilot process for obtaining information from these conglomerates has been initiated.

The year 2004-05 has witnessed a surge in credit off-take leading to a sizeable decline in the liquid assets of the bank. Consistent with the shift to functioning in a competitive economy and to the adoption of prudential best practices, the major challenges facing the banking sector are the deployment of funds in quality assets and the management of revenues and costs.

BASEL II

Unlike Basel I, which is simple, Basel II is complex. Therefore, the Basel Committee on Banking Supervision (BCBS) does not expect Basel II to be adopted widely or quickly. They believe that countries should adopt the options and approaches that are most appropriate for the state of their markets, their banking systems, and their supervisory structures. Supervisors can adopt the framework on an evolutionary basis and use elements of national discretion to adapt it to their needs.

INDIAN APPROACH TO BASEL II

With the commencement of the banking sector reforms in the early 1990s, the RBI has been consistently

upgrading the Indian banking sector by adopting international best practices. The approach to reforms is one of having clarity about the destination as also deciding on the sequence and pace of reforms to suit Indian conditions. This has helped us in moving ahead with the reforms without disruption. With the successful implementation of banking sector reforms over the past decade, the Indian banking system has shown substantial improvement on various parameters. It has become robust and displayed significant resilience to national and international shocks. There is ample evidence of the capacity of the Indian banking system to migrate smoothly to Basel II norms.

The policy approach to Basel II in India is such that external perception about India conforming to best international standards is positive and is in our favour. Commercial banks in India will start implementing Basel II with effect from March 31, 2007. They will initially adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk. After adequate skills are developed, both by the banks and also by the supervisors, some banks may be allowed to migrate to the Internal Rating Based (IRB) Approach.

Some of the regulatory initiatives taken by the Reserve Bank of India, relevant for Basel II are as follows:

Firstly, it has tried to ensure that the banks have suitable risk management frameworks oriented towards their requirements dictated by the size and complexity of business, risk philosophy, market perceptions and the expected level of capital.

Secondly, Risk Based Supervision (RBS) in 23 banks has been introduced on a pilot basis.

Thirdly, RBI has been encouraging banks to formalize their Capital Adequacy Assessment Process (CAAP) in alignment with their business plans and performance budgeting systems. This, together with the adoption of RBS, would enable factoring in of the Pillar II requirements under Basel II.

Fourthly, RBI has been expanding the area of disclosures (Pillar III), so as to have greater transparency in the financial position and risk profile of banks.

Finally, RBI is also trying to build capacity for ensuring the regulator's ability for identifying and permitting eligible banks to adopt IRB / Advanced Measurement approaches.

As per normal practice, and with a view to ensuring a smooth migration to Basel II, a consultative and participative approach has been adopted for both designing and implementing Basel II. A Steering Committee comprising senior officials from 14 banks

(public, private and foreign) has been constituted with representation from the Indian Banks' Association and the RBI. The Steering Committee had formed sub-groups to address specific issues. On the basis of recommendations of the Steering Committee, draft guidelines to the banks on implementation of the New Capital Adequacy Framework have been issued.

Implementation of Basel II will require more capital for banks in India due to the fact that operational risk is not captured under Basel I, and the capital charge for market risk was not prescribed until recently. Though the cushion available in the system, which at present has a CRAR of over 12 per cent, is comforting, banks are exploring various avenues for meeting the capital requirements under Basel II.

Even while RBI has decided to take the Indian banking system on to the simple approaches under Basel II, it has taken some initiatives which would clearly demonstrate that it has no intentions of either diluting the standards or picking on the less stringent options laid down in Basel II. Through these initiatives, RBI has prescribed stringent prudential requirements for banks in India e.g. with regard to adoption of risk weights for claims on State Governments, Public Sector Enterprises, banks and for capital market and real estate exposures. Further even though banks can be allowed to use unsolicited ratings under the Standardised Approach, RBI would not allow the use of unsolicited ratings.

RBI also has been expanding the area of disclosures so as to have greater transparency with regard to the financial position and risk profile of banks. Illustratively, with a view to enhancing further transparency, all cases of penalty imposed by the RBI on the banks as also directions issued on specific matters, including those arising out of inspection, are to be placed in the public domain. Such proactive disclosures by the Regulator are expected to have a salutary effect on the functioning of the banking system. In addition to the above, any penal action taken against any foreign bank branches in India are also shared with the Home country regulator with a view to enhance the quality of consolidated supervision. These initiatives will be an important supplement to the Pillar III disclosures prescribed under Basel II, which will further facilitate the cause of a stable banking system.

Banking will remain a highly dynamic industry. Supervisors will have to be especially attentive to changing best practices and ensure that Basel II does

not inhibit adoption of new banking practices and financial instruments. Maintaining financial stability in global banking and financial markets continues to be an important objective of regulators, bankers, and other market participants, particularly because of the negative impact that financial instability has on economies as a whole. Basel II, will help to improve financial stability, even though minimum regulatory capital ratios are likely to be more volatile under Basel II, this reflects greater risk sensitivity.

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ATTUNING TO GLOBAL GOVERNANCE NORMS – INDIAN PERSPECTIVE

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INTRODUCTION

The transformation from command economies to market-oriented economies, the rapid development and global proliferation of information and communications technologies, the growth of knowledge-based industries and services sector and the continuing integration of the world economy through trade and investment - all these have created the foundation for a new age of sustainable human development. Changes in the world's economic, political and social systems have indeed brought unprecedented improvements in human living conditions in both developed and developing countries. Here the trend towards globalisation deserves special attention as it has profound implications for governance, putting the government under greater scrutiny, leading to improved state conduct and more responsible economic policies.

In this article an attempt has been made to highlight the need for participation of State, private sector and civil society in the governance process. The article also highlights the initiatives taken by the government particularly in the context of regulatory governance for businesses.

CONCEPT OF GOVERNANCE

The concept of governance is not new. However, it has assumed the present prominence in the light of unprecedented changes that are taking place all around the world. The World Bank has defined that the good governance is epitomized by predictable, open and enlightened policy-making, a bureaucracy imbued with a professional ethos acting in furtherance of the public good, the rule of law, transparent processes, and a strong civil society participating in public affairs.

United Nations Development Programme (UNDP) views Governance as the exercise of political, economic and administrative authority in the management of a

country's affairs at all levels. It comprises mechanisms, processes and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations, and mediate their differences.

Organisation for Economic Cooperation and Development (OECD) defines governance, as the use of political authority and exercise of control in a society in relation to the management of its resources for social and economic development. This broad definition encompasses the role of public authorities in establishing the environment in which economic operators function and in determining the distribution of benefits.

It is, therefore, clear that the term governance encompasses political, social and economic governance including corporate governance, which has over the years gained momentum and a wider meaning. Apart from being an instrument of public affairs management, or a gauge of political development, governance has become a pre-requisite for competitive advantage for sustainable growth of business.

Major Constituents of Governance

Governance encompasses the state, but it transcends the state by including the private sector and civil society organisations. The private sector covers private enterprises (manufacturing, trade, banking, cooperatives and so on) and the informal sector in the marketplace.

Civil society, lying between the individual and the state, comprises individuals and groups (organised or unorganised) interacting socially, politically and economically - regulated by formal and informal rules and laws. Therefore, the institutions of governance in the three domains - state, civil society and the private sector must be designed to contribute to sustainable growth and development of the country.

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BACKGROUND

Efficient governance requires effective institutions. The efficiency and effectiveness of institutions, in turn, depends on their adopted delivery mechanism and the supportive framework of rules and procedures. Each of these has to work in harmony with the other to discharge the functions and roles for which the institutions have been created. More importantly, with changing context— domestic as well as global – a change in the profile and requirement of the society and with development, there has to be a capacity for evolution, the continuous adaptation in each of these elements. In the absence of such a capacity, governance invariably suffers. If institutions fail to keep up with the changing context and the supportive framework of rules and procedures become out of tune with the prevalent delivery mechanism, the institutions, may fail to deliver on their objectives satisfactorily.

Elements of Good Governance

- *Participation* - All men and women should have a voice in decision-making, either directly or through legitimate intermediate institutions that represent their interests. Such broad participation is built on freedom of association and speech, as well as capacities to participate constructively.
- *Rule of law* - Legal framework should be fair and enforced impartially.
- *Transparency* - Transparency is built on the free flow of information. Processes, institutions and information should be directly accessible to those concerned with them, and enough information is provided to understand and monitor them.
- *Responsiveness* - Institutions and processes should serve all stakeholders.
- *Consensus* - Good governance mediates between differing interests to reach a broad consensus on what is in the best interests of the group or where possible, on policies and procedures.
- *Equity* - All men and women have opportunities to improve or maintain their well-being.
- *Effectiveness and efficiency* - Processes and institutions produce results that meet needs while making the best use of resources.
- *Accountability* - Decision-makers in government, the private sector and civil society organisations are accountable to the public, as well as to institutional stakeholders.

- *Strategic vision* - Leaders and the public have a broad and long-term perspective on good governance and human development, along with a sense of what is needed for such development.

CONCEPT OF CORPORATE GOVERNANCE

As we have seen above, corporate governance is a species of a larger genus - the governance. Corporate governance is the system by which companies are run. It relates to the set of incentives, safeguards and dispute resolution process that are used to control and co-ordinate the actions of the agents on behalf of the shareholders by the Board of Directors. At the center of the corporate governance system is therefore, the Board of Directors, the composition of which is determined by shareholders. Their responsibilities are defined by statutes and their position.

Corporate governance today is a strategic necessity where focus is on quality of governance. Capital and investments from international investors are available to corporates demonstrating good governance practices and thus helping them both in procuring capital at competitive rates and also in employing and retaining the intellectual capital. Research studies have established that shareholders and stakeholders reward corporates conforming to norms of corporate governance in letter and spirit as they respond positively to them.

There is no universal definition of corporate governance. In the narrowest sense, Noble laureate Milton Friedman defined corporate governance as “the conduct of business in accordance with shareholders’ desires, which generally is to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs.” In a broader sense, James Wolfensohn, president of the World Bank, defined corporate governance as the “promotion of corporate fairness, transparency, and accountability.”

Sir Adrian Cadbury while defining corporate governance said that it is a system by which companies are directed and controlled and thus brought into sharp focus the role of board, shareholders and management. Corporate governance extends far beyond the confines of corporate law. The quality, quantity and frequency of financial disclosures, the extent of exercise of fiduciary responsibilities and duties by the boards towards shareholders and stakeholders, accountability and transparency in corporate functioning for maximizing shareholders’ wealth are the progressive elements and indeed, the underlying spirit of corporate governance.

Effective corporate governance mechanism provides for corporate ombudsmen and encourages whistle blowers to dissent when the interests of the Company are potentially in jeopardy. It is believed that corporate governance is limited to the highest levels of the company - perhaps the Chairman or the Board of Directors alone, but it indeed is the responsibility and privilege of each and every stakeholder.

While corporate governance is an important element affecting the long-term financial health of companies, it is only part of the larger economic context in which firms operate. Corporate governance framework depends on the legal, regulatory and institutional environment. Business ethics and corporate awareness of the environmental and societal interests of the communities in which it operates also impact the reputation and long-term success of a company. If companies are to reap the full benefit of the global capital market, capture efficiency gains, reap the economies of scale and attract long term capital, corporate governance standards must be credible, consistent coherent and inspiring.

Value Addition through Good Corporate Governance

- Good governance provides a competitive advantage in the global marketplace.
- Well-governed companies raise capital widely, easily, and cheaply.
- Good governance leads to improved employee morale and higher productivity.
- Well-governed companies last longer.
- Good governance provides stability and growth to the enterprise.
- Good governance system, demonstrated by adoption of good corporate practices, builds confidence.
- Effective governance reduces perceived risks, consequently reducing cost of capital.
- Good corporate practices promote stability and long-term sustenance of stakeholders' relationship.
- A good corporate citizen becomes an icon and enjoys a position of pride.
- Potential stakeholders aspire to enter into a relationship with enterprises whose governance credentials are exemplary.

GOVERNMENT INITIATIVES TOWARDS REGULATORY GOVERNANCE FOR CORPORATES

As a consequence of increasing interconnectedness and interdependence the structures of national governance are all for change in the course of globalisation. The quest for more mobility and efficiency have compelled the nations to open up their borders and allow globalisation to expand and grow, however, within the national governance system. As globalisation requires a national governance system to conform to global norms, the agenda for market oriented reforms process encompassed legislative reforms, complementing and supplementing the policy orientations to meet the desired objectives of the whole process.

With the initiation of economic reforms process in July 1991, the Government has initiated the process of Regulatory Reforms to suit the changing policy orientation and to fulfill its obligations under WTO. In the process, the Government enacted various new laws, amended existing legislations to provide a conducive economic and corporate legal environment. Some of the important initiatives towards attuning the governance norms conforming to requirements of globalisation includes reforms in corporate and economic legislations encompassing company law, securities laws, foreign exchange law, intellectual property law and competition law. This is an ongoing process.

New Governance Norms for Companies

The governance framework dealing with incorporation, management and even liquidation of the companies contained in the Companies Act, 1956. The Company Law, an ever-evolving subject, has undergone major transformation in the last decade. The impetus for such transformation germinated partially from the worldwide move for market oriented polices and partially by disquieting features of globalisation, resulting into focused attention on need for Good Corporate Governance. The advancements in information technology and influence of faster means of communications over corporate operations have also provided impetus for such transformation. In other words, the paradigm shift witnessed in the global economy and corporate sector the world over, have cumulatively presented various issues that have triggered debate and become important factors for initiating changes in Company Law in India and abroad.

With the initiation of market-oriented policies in July 1991, the Government has expedited the process to modify the company law in line with policy objectives

and to harmonise it with the international standards. In this direction a Working Group was constituted in the year 1996 to re-write the Companies Act, to facilitate healthy growth of Indian corporate sector under a liberalised, fast changing and highly competitive business environment. Based on the recommendations of Working Group Companies Bill, 1997 was introduced to replace the Companies Act, 1956. Since the Bill of 1997 was under consideration and an urgent need was felt to amend the Companies Act, the President of India promulgated the Companies (Amendment) Ordinance, 1998 which was later replaced by the Companies (Amendment) Act, 1999 to surge the capital market by boosting morale of national business houses besides encouraging FII's as well as FDI in the country, and to tailor the Companies Act in consonance with the then prevailing economic environment and to further Government policy of deregulation and globalisation of economy.

To expedite the harmonization process, the Companies Act was further amended in the year 2000 to provide certain measures of good corporate governance and for ensuring meaningful shareholders' democracy in the working of companies.

Two years later, the Companies (Amendment) Act, 2002 was enacted with the main objective of facilitating formation of cooperative business as companies and also to convert existing cooperatives into companies. Similarly, the Companies (Second Amendment) Act, 2002 provided for setting up of a National Company Law Tribunal having powers and jurisdiction, presently vested with Company Law Board/BIFR or Appellate Authority for Industrial and Financial Reconstruction or High Court. The Amendment Act aimed at reducing the entire process which was taking several years in winding up of the companies to about two years. The amendment Act is yet to come into force. In the mean time, consequent to the Enron debacle, which had shaken the whole world and brought the corporate governance in sharp focus, the Sarbanes Oxley Act was enacted, providing for stringent corporate governance requirements. Accordingly, as part of the process of attuning governance norms with global standards, the government constituted a Committee on Corporate Audit and Governance (The Naresh Chandra Committee).

Based on the recommendations of Naresh Chandra Committee, joint parliamentary Committee on Stock Market Scam and R D Joshi Committee on remaining provisions of the Companies Bill, 1997, the Government

introduced the Companies (Amendment) Bill, 2003 in the Parliament on 7.5.2003.

Recently the Government has initiated a fresh exercise for bringing a new Company Law on the basis of a broad based consultative process by releasing a Concept Paper for public debate. To put the various proposals contained in the Concept Paper and the suggestions received thereon to a merited evaluation, to address the changes taking place in the national and international scenario and to enable timely adoption of internationally accepted best practices, the Ministry of Company Affairs constituted an Expert Committee under the Chairmanship of Dr. J J Irani. The Committee worked on the underlined philosophy that in a competitive and technology driven business environment, great autonomy of operations and self-regulation must be matched with enhanced responsibility on the part of the corporate sector. The Committee has submitted its Report to the Ministry of Company Affairs on 31.5.2005.

Governance Norms for Capital Market

Today, the legislative framework dealing with securities markets comprises of Securities Contracts (Regulation) Act, 1956, Depositories Act, 1996 and various regulations and guidelines issued by Securities and Exchange Board of India (SEBI) under the SEBI Act, 1992 including listing agreement of the Stock Exchanges. The government and the SEBI as capital market regulator has taken various steps towards strengthening governance mechanism in capital market. The government amended the Securities Contract Regulation Act and Depositories Act to provide for demutualisation and corporatisation of stock exchanges, delisting of securities, permission to brokers of one exchange to trade with that of another so as to consolidate the market of the small exchanges and strengthen the penal framework for violation of securities law. Similarly, SEBI Act was also amended empowering SEBI to check cases of insider trading, fraudulent and unfair trade practices and market manipulation in order to protect the investors and to levy stringent penalties. To ensure that all constituents of governance process, the private sector and civil society participate in the evolution of governance norms, SEBI established a consultative mechanism by placing reports of the Committee and draft regulations on its website for public comments and views.

In order to strengthen the Corporate Governance of listed companies SEBI constituted a Committee on Corporate Governance under the Chairmanship of Kumar

Mangalam Birla. Based on the recommendations of the Committee, the SEBI had specified Corporate Governance norms for listed companies and introduced a new clause 49 in the Listing agreement of the Stock Exchanges in the year 2000. Later, as part of constant efforts to benchmark the standards of corporate governance SEBI constituted another Committee on Corporate Governance under the Chairmanship of Shri N. R. Narayana Murthy. The Committee in its Report observed that “the effectiveness of a system of Corporate Governance cannot be legislated by law, nor can any system of Corporate Governance be static. In a dynamic environment, system of Corporate Governance needs to be continually evolved.” Based on the recommendations of the Committee, SEBI revised clause 49 of the Listing agreement in August 26, 2003, the implementation of which was deferred later. The Securities and Exchange Board of India on October 29, 2004 again revised the Clause 49 of the Listing Agreement, w.e.f. March 31, 2005. However, SEBI extended the date for ensuring compliance with the revised clause 49 of the listing agreement to December 31, 2005, keeping in view the fact that large number of companies were not in the state of preparedness to comply with revised governance norms.

Governance Norms for Management of Foreign Exchange

Exchange control regime was introduced in India immediately after the outburst of the Second World War. Control was administered under the emergency powers derived from Defence of India Rules, which were later placed on a statutory pedestal through enactment of the Foreign Exchange Regulation Act, 1947. The Foreign Exchange Regulation Act, 1973 (FERA) was subsequently enacted to consolidate and amend the law in several respects, encompassing the experience gained over two decades of implementation of control through the earlier enactment of 1947, and considering the report of the Study Group on the question of leakage of foreign exchange through invoice manipulation and the Law Commission report on the Trial and Punishment of Social and Economic offences.

Experience gained over the years in the administration of the Foreign Exchange Regulation Act, 1973 had shown that certain provisions, meant to deal with emergencies of different kinds, are no longer relevant and are required to be removed for improving the climate for foreign investment in India. Hence, the Foreign Exchange Regulation Act, 1973 was reviewed in 1993 and several amendments were enacted as part of the on-going process of economic liberalisation

relating to foreign investment and foreign trade for closer interaction with the world economy.

However, in view of the significant developments that had taken place since 1993 such as substantial increase in foreign exchange reserves, growth in foreign trade, rationalisation of tariffs, liberalisation of Indian investments abroad, increased access to external commercial borrowings by Indian corporates and participation of foreign institutional investors in stock markets in India, a Bill to repeal and replace the Foreign Exchange Regulation Act, 1973 was introduced in Lok Sabha on 4th August, 1998. The said Bill was referred to the Standing Committee on Finance, which submitted its report to the Parliament on 23rd December, 1998 with certain modifications and suggestions. After incorporating certain modifications and suggestions of the Standing Committee on Finance, the Central Government introduced the Foreign Exchange Management Bill 1999 in the Parliament to repeal the Foreign Exchange Regulation Act, 1973. The Government notified the Foreign Exchange Management Act (FEMA) w.e.f. June 1, 2000 putting to end the era of control and ushering in the era of foreign exchange management. Thus the governance norms for foreign exchange and currency have been designed to meet the requirements of globalisation process initiated by the Government in the year 1991.

It may be said that the present law is an attempt to move from control regime to flexible management approach and regulation by the guidelines issued by the RBI and the Central Government from time to time.

Governance through Enhanced Competition

Governance in market framework dealing with competition in India spread over various legislations, besides the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP Act) which is the principal legislation dealing with Monopolistic and Unfair Trade Practices since 1969. Other legislations include Consumer Protection Act, 1986, Prevention of Food Adulteration Act, 1954, Standards of Weights & Measures Act, 1976, Packaged Commodities Rules, 1977, Patents Act, 1970, the Customs Tariff (Amendment) Act, 1995 and SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997.

With the growing complexity of industrial structure and the need for achieving economies of scale for ensuring higher productivity and competitive advantage in the international market, and a shift in the thrust of the industrial policy to control and regulate the monopolistic, restrictive and unfair trade practices rather

than making it necessary for certain undertakings to obtain prior approval of the Central Government for expansion, establishment of new undertakings, merger, amalgamation, take over and appointment of directors, the MRTP Act was amended in 1991.

However, the governance norms contained in MRTP Act were found to be outdated in terms of Government policies and international developments, therefore the government constituted a Committee to examine the provisions of the MRTP Act, in the light of international economic development relating to competition law to suit Indian conditions and to propose a modern competition law suitable to the needs of the country. The Committee in its report recommended the repeal of MRTP Act and enactment of new Indian Competition Law and establishment of Competition Commission of India to implement the new Act and to take up the Monopolistic and Restrictive Trade Practices cases pending before the MRTP Commission. Committee also recommended the abolition of MRTP Commission and suggested transfer of cases of Unfair Trade Practices to the concerned consumer Courts. Thus, based on the recommendations of the Committee, the Government introduced in the Parliament the Competition Bill containing new governance norms for fair competition. The major provisions of the Bill include :

- to ensure fair competition in India by prohibiting trade practices which cause appreciable adverse effect on competition in markets within India;
- establishment of a quasi-judicial body to be called the Competition Commission of India (CCI) to undertake competition advocacy for creating awareness and imparting training on competition issues;
- to curb negative aspects of competition;
- investigation by the Director-General for the Commission;
- to empower CCI to levy penalty for contravention of its orders, failure to comply with its directions, making of false statements or omission to furnish material information, etc.
- to create a fund to be called the Competition Fund;
- repeal the Monopolies and Restrictive Trade Practices Act, 1969 and the dissolution of the Monopolies and Restrictive Trade Practices Commission.

The Competition Act, 2002 has since been passed by the Parliament to provide, keeping in view of the

economic development of the country, for the establishment of a Commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India.

ERNST & YOUNG CORPORATE GOVERNANCE WEB SURVEY (2005)

The Ernst & Yong Corporate Governance Web Survey conducted in May and June, 2005 indicates that the corporate governance, while already a critical issue facing large corporations, is becoming more important as companies operate in an increasing complex regulatory environment. The summary of the findings of the survey is given below :

1. Differing Perspectives of the CEO/CFO and the Board

- The survey suggests a clear demarcation in the views of management including CEOs/ CFOs and the Board. In most cases, managements were found less positive than Board on governance issues.
- CEOs and CFOs and other management people were found to be generally less positive than board members about the capacity of their organisation to address corporate governance issues and the extent to which clear business policies exist.
- Board members see a greater role for themselves in debating company strategy rather than setting the broad strategic objectives. In contrast, CEOs and CFOs believe that the primary role of the Board is in setting strategy and reviewing management performance.
- Management was found more skeptical than the Board about Board effectiveness. 43% of management (vs 27% Board members) do not believe that the Board is especially effective at providing an independent overview and assessment of management performance. In addition, 40% of management (vs. 29% Board) do not believe that the Board is effective in ensuring that the principles of corporate governance are being implemented.

2. Communication and Support of Good Corporate Governance

- There is room for improvement in communicating the principles of corporate

governance. Only a third of management believes that these are widely disseminated throughout their organisation. Similarly, 59% of investors indicate that they are not well informed about the policies of the companies in which they invest.

- The governance is not yet central to the daily operation of companies; only 35% of board members and 36% of management strongly agree that the culture of their organisation is supportive of good corporate governance.

3. Audit Committee and Internal Audit Function

- While the majority of respondents report that their company has a Board audit committee (80%), in most cases, there are less than five members. The survey highlighted that the greater the revenue, the higher the percentage of respondents who have an audit committee of board members.
- The difference in management and board member points of view applies to perceptions of how effective the Audit Committee is in providing oversight of independent financial reporting. While 62% of board members strongly agree that the audit committee provides an appropriate level of oversight, only 23% of senior management (CEO/CFO) strongly agree. 37% of CEO/CFOs rate the audit committee as adequate or less than adequate in its central responsibility.
- Over two thirds of respondents were from organisations that have an internal audit function. Interestingly, more than 50% saw this function as reporting to the Audit Committee - indeed almost 60% saw this as Board responsibility if the “reporting to the Board” responses are added. In a further 20% of companies, the internal audit function reported to the CFO.
- Nearly half of each group (Board members 44% and CEO/ CFO/other management 47%) feel that a balance exists between risk management and management for growth within their company.

4. Risk Management Policy & Responsibility

- While Board members are generally more positive about governance and risk issues in their organisations, they are slightly less

knowledgeable about the policies in place, perhaps reflecting their distance from concrete implementation. CEOs and CFOs are more likely than Board members to say that the company has a clear policy in place to identify and to assess risk.

- Board members see the CEO as the person with primary risk management responsibility and may see this as an aspect of the leadership role that cannot be delegated.
- The CFO is most likely to be seen as the “owner” of risk management in the US (40% US vs. 24% UK), whereas it is more likely to be the CEO in the UK (39% UK vs. 12% US).
- Overall, fewer respondents see the Chief Risk Officer as the primary owner of risk within the company; the highest percentage, (32%) being other management, the group most likely to take on the role.
- Only a very small number of respondents saw risk management as primarily the responsibility of the Board.

5. Risk Management Committee

- Most companies (72%) have not established a separate Risk Management Committee. A third (32%) of UK companies, in comparison with 14% of US companies have a risk management committee.

6. Shareholder / Investor Opinions

- Most shareholders report that they have limited information about corporate governance policies. Even when prompted, investors didn't report a high level awareness of any of the principles of good corporate governance.

BENCHMARKING GOVERNANCE NORMS BY COMPANIES

As mentioned in preceding paragraphs and highlighted in the corporate governance web survey it becomes clear that the term governance is different for different people. It indeed is a way of thinking, philosophy and attitude. It encompasses the philosophies and processes in an organisation that enable its people to weigh competing objectives, challenges, and opportunities and consistently find the appropriate balance and direction. Thus, companies intent on improving governance need to start by enhancing processes, and changing attitude. Governance is really

about creating trust which cannot be legislated. It has to come through principles based approach. Companies must have fundamental internal controls and processes in place to implement the principles and concepts and to ensure that they are followed consistently. Finally, it should be understood that corporate governance is all about people. The best intentions and the most carefully designed processes will serve no purpose unless people at all levels have the intelligence, skills and, the strength of character to make the right and sometimes difficult decisions. Berry F. Kroeger in his article "Strengthening Corporate Governance" has suggested some areas of focus for boards and management to consider as they assess their governance norms and practices.

1. The Board

- In addition to reexamining its fundamental charter in the light of the current environment, the board should take a fresh look at committee structures, mandates, membership, and how committees are communicating about issues of mutual interest.
- Most Boards understand that the so called Tone from the top, must emanate from Boardroom as well as from the top management. The Board members need to seriously consider how its role is defined and the optimum balance of power between the Board and management.
- Meaningful continuing education for the board members is essential, so that they possess the adequate knowledge to probe and ask the necessary questions to adequately discharge their responsibilities.

2. Audit committees

- Audit committees should examine in greater detail the nature and extent of both internal and external audit and the interaction between the two. The audit Committee should ensure that it understands the basis for management's conclusion about the quality of internal audit, including management's priorities. It should also explore how audit scopes are shared between the two and whether there is good communication and knowledge sharing between them.
- In respect of quality of external audit, the Audit Committee should understand the judgements made in setting audit scopes and in evaluating the results of audit procedures.

3. Management

- Companies must find a way to properly balance the need to address the competitive forces with the need to consistently do the right thing. The CEO should play a critical role in achieving and maintaining this balance.
- As the business is becoming more competitive than ever before, this is a time to address issues such as:
 - (a) How open and candid is communication throughout the company both vertically and horizontally ?
 - (b) How are different points of view resolved?
 - (c) How does the company deal with failure of initiatives or missed financial or operating results ?
 - (d) Do incentives reward all of the right behaviors of employees ? and
 - (e) Are the messages from the top - both formal and informal- appropriately balanced?
- The management together with the Board should reevaluate the completeness and appropriateness of their governance policies and practices. In this direction, the companies should address whether necessary mechanisms are in place to provide employees at all levels with access to senior management
- Companies should evaluate systems and practices, especially those with implications to financial reporting and governance issues.
- In the light of sharp focus on expanded financial disclosure requirements, it is important for companies to identify and challenge who is responsible for determining asset valuations and other critical estimates; the quality of underline data; and the process for reviewing the initial determinations

The defining difference between companies with great governance and others is not whether they address governance-related issues but the depth and rigor with which they do so and their willingness to make the tough decisions. Like strategy, success of a company in benchmarking governance norms, lies in its willingness and effective execution.

CONCLUSION

Clearly, Governance has occupied the Centre-stage in today's efforts to improve the quality of life, efficiency of an organisation, and ensuring the best value for money. To govern is to rule or control with authority and conduct the policy and affairs of an organisation. The process involves influencing and determining the course of action.

The issue of improving governance in the country has to be addressed at multiple levels. The relevance and the operations of institutions concerning the social, economic and political processes towards the goals of development will have to be re-examined, particularly in view of the current context, which, in many cases, is vastly different from the context that may have led to their creation.

Elimination of unnecessary procedural controls and regulations that stifle entrepreneurial energy, breed corruption and affect the common man has to be a priority area of improving governance. Rationalisation of rules, notifying them in a comprehensive and transparent manner, assigning accountability of each functionary and providing administrative and legal recourse in case of malafide dilatoriness are necessary to address the problem of crisis of Governance. These are issues in governance that have to be addressed on a priority as they impinge on the success of economic reforms.

Despite the diversity of corporate governance system, the globalization of markets is producing a degree of convergence in actual operations and governance practices. The global market pressures are providing the impetus for private sector to harmonize corporate governance practice – to reduce risks to investors and hold down the cost of capital to corporations. It is well recognised that the Corporate governance cannot be regulated as its fundamental objective is not mere fulfillment of the requirements of law but in ensuring commitment of the board in managing the company in transparent manner for maximising long-term shareholder value. It is about establishing a climate of trust and confidence.

Benchmarking governance norms is fundamentally a political, social and economic process in which government, the private sector and civil society have to join hands. Like democratic governments, business must be governed by a set of rules that reflect the interests of their shareholders and the public at large. These rules of the game for businesses are an important dimension of reform efforts in developed and transition

economies alike. Countries that ignore or lag behind in improving corporate governance norms will rapidly find themselves at a competitive disadvantage in attracting long-term capital for development. Therefore, there is an imperative need to undertake efforts to push for stronger governance institutions. Public education efforts are needed to promote better understanding of essential governance principles and their relationships to democratic development; and Companies need to undertake voluntary reforms by developing codes of conduct and best practices guidelines as suggested in the preceding paragraphs.

As the globalisation takes place and Corporate Governance becomes increasingly important in determining the perception of international investor, managerial structures and credibility of business, there is need for corporates in India to heed this tide of change. They must proactively design their culture specific codes and effectively implement, instead sit and wait for rules to be imposed from the Government and regulatory agencies.

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SECURITIES LAWS AND CAPITAL MARKET – GLOBAL BENCHMARKING

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INTRODUCTION

The sensex crossed the 8000 mark achieving historic high and growing. There is strong view suggesting that a vibrant securities market is a vehicle for disseminating opportunities and mitigating economic deprivation. The Indian securities market which has undergone revolutionary changes over a period of time, is said to be not only at par with global standards on many parameters, in some, it is ahead of the global standards. So when one benchmark with best in the world, what could be the future road map? This indeed is a complex task particularly when the future looks non linear, discontinuous and unpredictable. Therefore, the future, road map for benchmarking rest in the innovation, creativity and capability to deal with future.

This article is an attempt to discuss the operational, systemic and regulatory developments in capital market in India. The article beginning with the structure and spread of capital market discuss in detail the continuous efforts being made by SEBI – the capital market regulator– towards further refining the governance system and suggested areas for further benchmarking.

CAPITAL MARKET STRUCTURE AND SPREAD

Capital market performs four functions namely, making available variety of opportunities to investors to park their disposable wealth; formation of capital both risk capital and debt capital; allocation of capital; and corporate governance. The performance of capital market and SEBI on these four counts has been exemplary, as it has achieved several milestones in making Indian capital market comparable to its counterparts in developed and emerging economies.

As per independent estimates by the Society for Capital Market Research & Development and SEBI-NCAER Survey, the population of shareowning individuals in India is around 2 crore. SEBI's registered market

intermediaries include 2 National level exchanges (Bombay Stock Exchange – BSE and National Stock Exchange – NSE) and 21 regional exchanges with fully electronic trading platforms. A 9359 companies were available for trading on stock exchanges at the end of March, 2004. The trading platform of the stock exchanges was accessible to 9368 brokers, 1829 derivative brokers and 12815 sub brokers from over 400 cities in the same period. The number of foreign institutional investor is 540, custodians 11, depositories 2, depository participants 431, Merchant Brokers 123, Bankers to an issue 55, Underwriters 47, Debenture Trustee 34, Credit Rating Agencies 4, Venture Capital Funds 45, Foreign Venture Capital Investors 9, Registrar to an Issue and Share Transfer Agents 78, Portfolio Managers 60 and Mutual Funds 37. The Mutual Funds with 396 schemes manages an asset base of nearly 22 US Billion dollars. During 2005-06 (April-August), the net resource mobilization by mutual funds was higher at Rs. 35,087 crore as compared to Rs. 12,014 crore during 2004 - 05 (April - August) - an increase of Rs. 23,073 crore. At the end of August 31, 2005, the net assets under management by mutual funds were Rs. 1,95,784 crore as compared to Rs. 1,55,686 crore in August 2004, an increase of 25.8%.

In terms of regulatory framework, there are strict disclosure and accounting norms for the listed companies and facility of book building in public offerings through a transparent price discovery mechanism is available to the issuers.

SEBI'S STRATEGIC ACTION PLAN

SEBI from its very inception has been continuously endeavouring to make the Indian Capital Market effective, transparent and investor friendly. In this direction, SEBI has undertaken several initiatives of far-reaching consequences, which have not only radically reformed but totally transformed Indian Capital Market.

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In fact SEBI's approach to the regulation has been developmental in nature with a long-term perspective on sustaining confidence of the stakeholders in the market. SEBI is persistently striving to ensure that objectivity and pragmatism is maintained in all its decisions and accordingly, the regulatory process is made extremely transparent, interactive and consultative vis-a-vis the stakeholders.

The SEBI has chalked out a vision of becoming the **"Most Dynamic and Respected Regulator-Globally"** and in order to realise the vision, SEBI has drawn a Comprehensive Strategic Action Plan aiming at investors, corporates, markets and regulatory regime.

Operationalisation of Strategic Action Plan

SEBI has taken following initiatives to operationalise the strategic Action Plan :

1. Investors

- (i) Electronic Data Filing and Retrieval System (EDIFAR), an automated web based system for filing, retrieval and dissemination of information pertaining to corporates have been made operational.
- (ii) In the case of debt oriented and balanced funds benchmarking has been made compulsory for providing objective analysis of the performance of the mutual fund schemes.
- (iii) A Code of conduct and Guidelines for Risk Management System for the valuation of unlisted equity shares and due diligence have been issued.
- (iv) Nomination facility for the unit holders has been introduced and Mutual Funds have been advised to follow a uniform method to calculate the sale and repurchase price to avoid confusion in the minds of the investors.
- (v) Rebating and discounting by the Mutual Funds has been prohibited for ensuring that all investors get fair treatment.

2. Markets And Intermediaries

- (i) The exchanges have been directed to follow compulsorily rolling settlement for all listed securities.
- (ii) Inter – depository transfer through on-line connectivity was established between CDSL and NSDL.
- (iii) Straight Through Processing (STP) on the securities market has been made operational.

- (iv) Exchanges have been directed to establish a comprehensive surveillance mechanism for tracking the derivative markets.
- (v) Disclosure of the fair value of the ESOPs (i.e. using Black Scholes or similar models), the impact on profits and on EPS of the company, had the company expensed the ESOPs on fair value basis and also lock in requirements subject to certain disclosures in the offer documents in case company is going for IPO after the grant of options, have been made mandatory.
- (vi) Half yearly audited consolidated results and quarterly audit review.
- (vii) Credit Rating Agencies have been asked to develop models for rating corporate governance on the principles of wealth creation, wealth management and wealth sharing.
- (viii) A code of conduct has been specified for listed entities for regulated firms under the Insider Trading Regulations.

Strengthening Regulatory Regime

The Strategic Action Plan aims to achieve an appropriate, proportionate and effective regulatory regime to ensure the confidence of all the stakeholders. In this direction, the SEBI Act, 1992 was amended in empowering SEBI to check cases of insider trading, fraudulent and unfair trading practices in securities markets and market manipulation in order to protect the investors and to levy deterrent penalties against corporates and individuals in such matters. The SEBI Board was enlarged with the provision of three full time Board members. The Securities Appellate Tribunal was converted into a three-member body with a sitting or retired judge of Supreme Court or a sitting or retired Chief Justice of High Court as the presiding officer. All the orders passed by the Securities Appellate Tribunal and Chairman, SEBI are being posted on the SEBI website, as an effort to enhance regulatory transparency.

Also, with a view to ensure that participation of regulates as also the nation at large in the process of designing the regulation will improve the efficacy of regulations, SEBI established a consultative mechanism by placing reports of committees and draft regulations on the SEBI website and seeking comments, suggestions and opinions. Besides the involvement of the regulatee in this process, the consultative mechanism has also ensured that the regulatee are aware of the changes in the regulatory framework in advance.

As a measure of proactive regulatory approach SEBI has been enacting new regulations and regulatory amendments in the existing areas. SEBI has enacted following new regulations and guidelines and amended the existing ones in the year 2004-05.

- (i) SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997 last amended on December 30, 2004
- (ii) SEBI (Portfolio Managers) Regulations, 1993 last amended on May 27, 2004
- (iii) SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002 last amended on June 6, 2005
- (iv) SEBI (Foreign Institutional Investors) Regulations, 1995 last amended on February 19, 2004
- (v) SEBI (Mutual Fund) Regulations, 1996 last amended on January 12, 2004
- (vi) SEBI (Depositories and Participants) Regulations, 2004 last amended on June 10, 2004.
- (vii) SEBI (Self Regulatory Organisations) Regulations, 2004 (notified on February 19, 2004)
- (viii) SEBI (Criteria for Fit and Proper Person) Regulations, 2004 (notified on March 10, 2004)
- (ix) SEBI (Interest Liability Regularisation) Scheme. 2004 (notified on July 15, 2004)
- (x) Notification under sub Regulation (1) of Regulation 6 of SEBI (Central Database of Market Participants) Regulations, 2003 (issued on March 31, 2005)
- (xi) SEBI (Venture Capital Funds) Regulations, 1996 last amended on April 5, 2004
- (xii) SEBI (Foreign Venture Capital Investors) Regulations, 2000 last amended on April 5, 2004)
- (xiii) SEBI (Buy back of Securities) Regulations last amended on June 18, 2004
- (xiv) SEBI (Informal Guidance) Scheme, 2003 last amended on January 21, 2004
- (xv) SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999, last amended on July 22, 2004
- (xvi) SEBI (Disclosure & Investor Protection) Guidelines, 2000, last amended on September 19, 2005.

DEVELOPMENTS IN SECURITIES LAWS

I. Securities Laws (Amendment) Act, 2004

The Securities Laws (Amendment) Act, 2004 was enacted to insert/ amend provisions in the SCRA and the Depositories Act to enable demutualization and corporatisation of the stock exchanges, fill up certain identified regulatory gaps such as units of MFs, delisting of securities, clearing corporation, for which there were no statutory provisions, allow a broker of one exchange to trade with that of another so as to consolidate the market of the small exchanges, and strengthen the penal framework for violation of securities laws.

Demutualisation of Exchanges

The Act makes it mandatory for all stock exchanges, if not corporatised and demutualised, to be corporatised and demutualised on and from the appointed date as notified in the official gazette by SEBI. The stock exchanges may submit within prescribed time, a scheme for corporatisation and demutualization to SEBI for its approval.

Definition of Securities

The Act expanded the definition of 'securities' to include units or any other such instrument issued to the investors under any Mutual Fund Scheme.

Delisting of Securities

The Act, incorporates a new provision to allow delisting of securities. A stock exchange may delist securities, after recording reasons, on any of the grounds as may be prescribed in the rules, after giving the company concerned an opportunity of hearing. A listed company or an aggrieved investor can file an appeal before SAT against the decision of the exchange to delist the securities.

Clearing Corporation

The Act inserted a new section in the SCRA to provide that an exchange may, with the approval of SEBI, transfer the duties and functions of a clearing house to a clearing corporation for the purpose of periodical settlement of contracts and differences thereunder, and delivery of and payment for securities. The various provisions in the SCRA such as grant and withdrawal of recognition, supersession of management, suspension of business etc. applicable to stock exchanges have been made applicable to clearing corporations *mutatis mutandis*.

Scheme of Penalty

The amendment makes all the offences listed in section 23 of the SCRA cognizable. It provided that these offences and all offences listed in section 23M(1) of the SCRA and section 20 (1) of the Depositories Act, on conviction, shall attract punishment in terms of imprisonment and/or fine, without prejudice to any award of penalty by the adjudicating officer.

The Amendment Act empowers SEBI to appoint adjudicating officers to adjudicate a wide range of offences, as listed under sections 23A to 23H in the SCRA and 19A to 19G in the Depositories Act and impose monetary penalties for such offences.

The Act provides that all sums realised by way of penalties imposed by the adjudicating officers would be credited to the Consolidated Fund of India. It further provides that non-payment of penalty imposed by an adjudicating officer or non-compliance with any of his orders or directions would be an offence punishable with imprisonment for a term between one month and ten years, or with fine up to Rs. 25 crore or with both.

Powers of SEBI

The Act has inserted a new section 12A in the SCRA to empower SEBI to issue appropriate directions in the interest of investors and the securities market to any stock exchange, clearing corporation and such other person or agency providing trading, clearing or settlement facility in respect of securities or to any company whose securities are listed or proposed to be listed in a stock exchange.

REPORT OF THE EXPERT GROUP FOR SUGGESTING AMENDMENTS TO SECURITIES AND EXCHANGE BOARD OF INDIA ACT, 1992

SEBI constituted an Expert Group headed by Justice M H Kania, Former Chief Justice of India on August 2004 to identify the deficiencies/inconsistencies in the existing provisions of the SEBI Act and also to suggest new provisions that can be incorporated in the SEBI Act to make it more effective and investor friendly, taking into account recommendations of the Joint Parliamentary Committee (2002) as also recommendations of other expert groups constituted by SEBI from time to time in this regard.

The Group after deliberating on the proposals made regarding amendments to SEBI Act in the light of comments thereon received from the stakeholders submitted its report in June 2005 recommending incorporation of new provisions in the SEBI Act;

amendments for changes in the existing provisions; and consequential and related amendments in other Acts. The major recommendations of the Group are summarized below :

1. Recommendations for incorporating new provisions in the SEBI Act

(i) Investor Protection Fund

The Group recommended that a separate Investor Protection Fund under the SEBI Act, on the lines of Subscriber Education and Protection Fund under Pension Fund Regulatory and Development Authority (PFRDA) Ordinance 2004 may be established for the purpose of investor education and awareness and for compensation to the small investors in respect of fraud or misrepresentations or misstatements by companies or intermediaries. The Group further recommended that the said fund be administered by SEBI to protect the investors and take measures for investor education and awareness and for compensation to the small investors in accordance with the established guidelines or parameters specified by SEBI on the lines of the guidelines in respect of stock exchanges. As to the composition of Fund, the Group recommended that there shall be credited to the said fund the following amounts namely:

- (a) Unclaimed dividend or interest under any mutual fund or Collective Investment Scheme (CIS) or venture capital and scheme for more than 7 years.
- (b) Any unclaimed money or securities of a client lying with an intermediary in securities market for more than 7 years;
- (c) Monies lying unutilized in the Investor Protection Funds of the stock exchanges.
- (d) All sums realized by way of monetary penalty under Chapter VIA of SEBI Act.

(ii) Nomination Facility

The Group recommended for a suitable amendment in the SEBI Act for incorporation of a provision to provide nomination facility to the unit holders of Mutual Funds and Collective Investment Schemes.

(iii) Winding up of intermediaries

The Group recommended that suitable provision in the SEBI Act may be made to enable SEBI to

file winding up petition in respect of the intermediary companies on the lines of Section 45MC of the Reserve Bank of India Act and Section 43A of the Banking Regulation Act.

(iv) *Non attachment of assets of clients with intermediaries*

The Group recommended that there should be a specific provision in the SEBI Act to the effect that the monies or securities of the clients should be held in the form of a trust by intermediaries and no authority shall attach or seize such assets of investors which are in possession of the intermediary.

2. Recommendations for amendment in the existing provisions of the SEBI Act

(i) *Registration and Regulation of Asset Management Company, Research Analyst, Clearing Corporation, STP Provider etc.*

The Group recommended that the SEBI Act may be amended to include Asset Management Company, stock lender and STP Service Provider in section 12 of SEBI Act. Section 12 of SEBI Act deals with the registration of stock brokers, sub-brokers, share transfer agents etc.

(ii) *Monetary Penalty for false information*

The Group recommended that SEBI Act, may be amended so as to empower SEBI to initiate adjudication proceedings for furnishing false information knowingly.

(iii) *Power to share information with overseas regulators*

The Group recommended that Section 11(2)(1a) may be amended to authorize SEBI to share information on reciprocal basis with overseas regulators on the lines of Sections 169 and 354 of the Financial Services and Markets Act, 2000 of UK.

(iv) *Inspection and Investigation*

The group recommended that sections 11(2A), 11C(9) and 11D be amended to bring them in harmony with Section 12A of the SEBI Act.

(v) *Attachment of Bank accounts of intermediaries*

The group recommended that Section 11(4) of SEBI Act may be amended so as to increase the period of attachment from one month to three months subject to further extension by

another three months upon the order of a Judicial Magistrate of First Class in writing.

(vi) *Maximum Penalty*

The group recommended that in Sections 15A to 15H of SEBI Act, the words "one lac rupees for each day during which such failure continues or one crore rupees, whichever is less" may be replaced by the words "not exceeding one lac rupees for each day during which such failure continues subject to a maximum of one crore rupees", for the sake of clarity.

(vii) *Failure to comply with the order of SEBI*

The group recommended that Section 15HB of SEBI Act, may be amended to provide for monetary penalty for the failure to comply with the orders of SEBI and to amend Section 24(2) to make non-compliance of SEBI order an offence under the provisions of the said section.

(viii) *Monetary Penalty to be transferred to Investor Protection Fund*

The group recommended that the SEBI Act may be amended on the lines of PFRDA Ordinance so that all the penalty amounts realized under Chapter VIA of the SEBI Act, are utilized for investors protection and education. The Group further recommended that suitable amendments in Section 15JA of the SEBI Act should also be made.

(ix) *Composition of Securities Appellate Tribunal*

The group recommended that an amendment in the SEBI Act be made so as to empower the Presiding Officer to constitute benches consisting of one or two members for hearing any appeal or interim application. It has also been provided that atleast one of the member of such bench is a judicial member.

(x) *Filing of complaint by SEBI-Deemed Public Prosecutor for prosecution*

The group recommended that a suitable amendment in section 26 of the SEBI Act, may be made to provide that the person conducting prosecution on behalf of SEBI, under SEBI Act before the Sessions Court shall be deemed to be a public prosecutor.

(xi) *Office of Single Enquiry and Adjudicating Authority*

The group recommended that SEBI Act may be amended to provide that an Enquiry and Adjudicating Officer appointed by the

Chairman/Whole-time Member may decide the matter of imposition of any type of penalty namely, suspension or cancellation of certificates of registration to be imposed by SEBI or monetary penalty under SEBI Act and Rules/Regulations made thereunder.

The Group further recommended for the Amendment of SEBI Act to provide for constitution of a three member standing committee to review all the orders passed by the Enquiry and Adjudicating Officers.

3. Recommendations for consequential and related amendments in other Acts

The group recommended that SEBI may in exercise of its powers under Section 11A of the SEBI Act, specify additional disclosures to be made by the companies and the power to amend Schedule II of the Companies Act may remain with the Central Government.

II. SEBI (DISCLOSURE & INVESTOR PROTECTION) GUIDELINES

SEBI had issued a compendium containing consolidated guidelines, instructions relating to issue of capital effective from January 27, 2000. The compendium titled SEBI (Disclosure and Investor Protection) Guidelines, 2000 replaced the original guidelines issued in June, 1992 and clarifications thereof. It also abandoned the issue related RMB General Instructions (GI) Series, circulars and other guidelines relating to preferential issue, advertisement, book building etc. Since the issue of consolidated guidelines in 2000, various changes have been made in the guidelines latest amendment being issued on September 19, 2005.

A. *The amendments to the DIP Guidelines as notified in January, 2005 may be classified under the four categories :*

- (i) Order of presentation of disclosures in prospectus;
- (ii) Requirements relating to abridged prospectus;
- (iii) Requirements relating to issue advertisements;
- (iv) Appointment of co-managers, advisors, etc.

Order of presentation of disclosures in prospectus

1. Section I dealing with contents of the prospectus of Chapter VI of the guidelines i.e. Contents of the Offer Document has been amended. Clauses of Section I have been

rearranged in the same order in which disclosures should appear in the prospectus.

2. All the disclosure requirements specified under Schedule II of the Companies Act, 1956 have been retained either under the same heading or under new headings.
3. Few requirements / sections have been added to make the prospectus more effective like summary, table of contents, industry review, etc.
4. Repetitive disclosures are required to be avoided by giving cross references to the extent possible.
5. An annexure indicating order of presentation of disclosures in the prospectus has been inserted in the guidelines for easy understanding.
6. Issuers are free to make additional disclosures, so long as they are not inconsistent with the guidelines. Further, the said disclosures have been, to the extent possible, brought within the broad headings as specified in Section I of the guidelines i.e. 'Contents of the Offer Document'.

Requirements relating to abridged prospectus

In order to achieve the objective of making the abridged prospectus more readable, the guidelines have amended Section II of Chapter VI of the guidelines which lays down the disclosure requirements in the abridged prospectus providing for :

1. increased readability/visual impact of the contents of the abridged prospectus.
2. deleting the repetitive disclosures, etc.
3. sequencing of items followed shall be the same as appearing in the prospectus.
4. supplementing the disclosures in abridged prospectus (As per Form 2A of the Companies Act, 1956) by such information as is considered most relevant for the prospective retail investors.

Requirements relating to issue advertisements

In view of the high cost involved in publishing the abridged prospectus and also to make available the abridged prospectuses along with the application form, SEBI guidelines have been amended to provide for the following:

1. Pre-issue advertisement has been made mandatory for all public issues.

2. The issue advertisements (pre-issue advertisements, issue opening or closing advertisements) have been required to contain the minimum details prescribed in the formats as specified in the guidelines.
3. The issue advertisements like issue closing or opening advertisement, continue to be optional.
4. The issuer company has an option of including additional disclosures in these advertisements so long as they are not inconsistent with the guidelines and subject to the same being in compliance with the principles and code of advertisements laid down in Chapter IX of the guidelines.
5. Any bill Board Advertisement in regard to an issue shall not contain information other than as stipulated in the formats specified in the guidelines.

Appointment of co-managers, advisors, etc.

The restriction on the number of co-managers and advisors which can be appointed in an issue has been removed. The disclosure(s) pertaining to issue expenses have also been enhanced.

- B. Amendments to the SEBI (Disclosure and Investor Protection) Guidelines, 2000 vide circular dated March 29, 2005 relate mainly to the book building process. Highlights of the amendments are as under:*

Retail Individual Investors (RIIs)

The RII, till date was defined in value terms as one who can apply for shares upto a maximum amount of Rs.50,000/-. SEBI has redefined the RII as one who can apply up to Rs.1,00,000/-.

Allocation category for retail individual investors

In a book built issue allocation to Retail Individual Investors, Non Institutional Investors (NIIs) and Qualified Institutional Buyers (QIBs) used to be in the ratio of 25: 25: 50 respectively. SEBI increased the allocation to RIIs from the existing 25% to 35% and correspondingly reduced the allocation to NIIs from the existing 25% to 15%.

Further, in case the book built issues are made pursuant to the requirement of mandatory allocation of 60% to QIBs in terms of Rule 19(2)(b) of SCRR, the respective figures are 30% for RIIs and 10% for NIIs.

Bidding period

Earlier, SEBI guidelines provided for a maximum bidding period of 10 days extendable by three more days, if there is a revision in price band. Through the amendment, SEBI has reduced the bidding period from 5 – 10 days (including holidays) to 3 -7 working days.

Timing of disclosure of Price Band/Floor Price

SEBI guidelines required all issuers (whether listed or unlisted), making a public issue through book building process to disclose the price band/ floor price in the Red Herring Prospectus (RHP)/application form. SEBI vide this amendment has given an option to **listed issuers** to either (a) disclose price band in RHP / application form/abridged prospectus (current practice) or (b) to disclose the price band /floor price atleast one day before bid opening.

Data reporting at website of stock exchanges

In order to ensure dissemination of relevant information in public domain, SEBI guidelines have been amended inter alia to improve the contents of and to ensure uniformity in data display on the websites of the concerned stock exchanges and to ensure availability of data for a further period of 3 days after the closure of the bids/issue.

- C. The DIP Guidelines as amended in August 2005 revised the provisions related to minimum public shareholding as follows:*

- (1) All listed companies are required to maintain atleast 25% shareholding with public for the purpose of continuous listing.
- (2) This is, however, not applicable to companies which are permitted to make an Initial Public Offer (IPO) of atleast 10% to public in terms of Rule 19(2)(b) of Securities Contracts (Regulation) Rules, 1957 (SCRR). Such companies are required to maintain atleast 10% public shareholding for the purpose of continuous listing.
- (3) The aforesaid minimum public shareholding requirement is not applicable to Government companies, infrastructure companies and companies registered with Board for Industrial Financial Restructuring (BIFR).
- (4) Listed companies, which are not presently complying with the minimum public holding requirement as mentioned above, have been given a period of two years, for compliance,

from the date of issuance of circular in this regard.

- (5) Listed companies which may in future fall short of the requisite minimum level as mentioned above on account of reasons like Corporate Debt Restructuring (CDR) packages etc. have been given a period of one year, for compliance, from the date of non-compliance.

The objective is to ultimately reach a single level of minimum public shareholding requirement for listed companies, in course of time. However, no time frame has been envisaged at this stage.

D. SEBI DIP guidelines have been further amended vide circular dated September 19, 2005 issued to all Registered Merchant Bankers/ Stock Exchanges. These amendments are applicable to the public issues through book building route, draft offer documents which, are filed with SEBI on or after the date of this circular.

Provision for specific allocation for mutual funds within the QIB category

Mutual funds registered with SEBI in terms of SEBI (Mutual Funds) Regulations, were not given any specific allocation within the QIB category in book-built issues. It has now been decided to provide 5% of the 50% or 60% {in case of issues in terms of Rule 19(2)(b) of SCRR} of net offer to public available for allocation to QIBs, for mutual funds.

Effectively, out of the portion available for allocation to QIBs, 5% will be available for allocation to mutual funds. All eligible bids by mutual funds will be considered for allocation in the afore mentioned 5% as well as in the balance available for QIBs. An illustration explaining the method of allocation to mutual funds has also been incorporated in the guidelines. In the event of inadequate response from the mutual funds, the shares may be made available to QIBs other than mutual funds.

Proportionate allotment to QIBs

Earlier, the allotment to QIBs was decided by Issuer Company in consultation with Book Running Lead Managers (BRLMs). Now the existing provisions of proportionate allotment as applicable for Retail individual investors (RIIs) and Non Institutional Investors (NIIs) have been extended to the QIB category. It has also been decided that where BRLMs have reasons not to accept a QIB bid, the same should be done at the time of receipt of the bids and the reasons therefor should be

disclosed to the bidders. Necessary disclosures in this regard are also required to be made in the offer document.

Margin requirements for QIBs

So far the guidelines did not mandate any specific margin for any of the categories eligible for applying in public issues, whether RIIs, NIIs or QIBs. However, in practice, in all the book built issues, there has invariably been 100% margin for RIIs and NIIs, but no margin for QIBs. It has now been decided to bring in margin of 10% in QIB category.

III. BENCHMARKING OPERATIONAL AND SYSTEMIC ENVIRONMENT

Innovations in the Securities Market

With a view to ensure that markets remain innovative in meeting the interests of all stakeholders and in furtherance of its consultative process, SEBI prepared and issued for public comments, a Discussion Paper on Innovations in the Securities Market, containing-

- (i) trading of rights on stock exchanges in electronic form;
- (ii) Strategic use of put options in the fixed price buy back and takeover cases;
- (iii) Buy-back of shares for other than the cash;
- (iv) Insurance and trading of third party warrants; put options and event risk in bonds; and
- (v) professional rating of the intermediaries.

Tracking Stocks

Dr. J J Irani Expert Committee constituted by the Government to make recommendation on the Concept Paper on Company Law has recommended in its report for the introduction of 'Tracking Stocks' in the Indian Capital market.

A tracking stock is a type of common stock that "tracks" or depends on the financial performance of a specific business unit or operating division of a company, rather than the operations of the company as a whole. As a result, if the unit or division performs well, the value of the tracking stocks may increase, even if the company's performance as a whole is not up to mark or satisfactory. The opposite may also be true.

A tracking stock is a special type of stock issued by a publicly held company to track the value of one segment of that company. By issuing a tracking stock, the different segments of the company can be valued

differently by investors. Tracking stocks are generally issued by a parent company in order to create a financial vehicle that tracks the performance of a particular division or subsidiary. When a parent company issues a tracking stock, all revenues and expenses of the applicable division are separated from the parent company's financial statements and bound to the tracking stock. Often this is done to separate a high-growth division from large losses shown by the financial statements of the parent company. The parent company and its shareholders, however, still control operations of the subsidiary.

Tracking stock carries dividend rights tied to the performance of a targeted division without transferring ownership or control over divisional assets. In contrast to a spin-off or an equity carve-out, the parent retains full control, allowing it to enjoy any operating synergies, or economies of scale in administration or finance.

Shareholders of tracking stocks have a financial interest only in that unit or division of the company. Unlike the common stock of the company itself, a tracking stock usually has limited or no voting rights. In the event of a company's liquidation, tracking stock shareholders typically do not have a legal claim on the company's assets. If a tracking stock pays dividends, the amounts paid depends on the performance of the business unit or division. But not all tracking stocks pay dividends.

A company has many good reasons to issue a tracking stock for one of its subsidiaries (as opposed to spinning it off to shareholders).

- (i) First, the company keeps control over the subsidiary (although they don't get all the profit), but all revenues and expenses of the division are separated from the parent company's financial statements and attributed to tracking stock. This is often done to separate a high growth division with large losses from the financial statements of the parent company.
- (ii) Second, they might be able to lower their costs of obtaining capital by getting a better credit rating.
- (iii) Third, the businesses can share marketing, administrative support functions, etc.
- (iv) Finally, if the tracking stock shoots up, the parent company can make acquisitions and pay in stock of subsidiary instead of cash.

When a tracking stock is issued, the company can choose to sell it to the markets (i.e., via an initial public

offering) or to distribute new shares to existing shareholders. Either way, the newly tracked business segment gets a longer lease, but can still run back to the parent company in tough times.

Advantages of Tracking Stock

A key advantage of tracking stock is that it offers divisional managers a degree of decision-making authority that might otherwise be unattainable, given top management's reluctance to dilute its control over the division's assets. The practical effect should be to enhance job satisfaction for divisional managers, thus reducing retention risk and also increasing the company's responsiveness to changing market conditions. Also, investors have more direct access to the specific businesses of the parent, which can be highly useful in the case of a diversified company. Another possible reason for the growing popularity of trackers is that trackers allow mainstream companies to exploit the dual stock market pricing between conventional and high-tech or Internet businesses. By creating tracked business units, conventional businesses too can benefit from the pricing frenzy.

Disadvantages of Tracking Stock

For investors, tracking stocks can be of a mixed bag. Like regular stocks, tracking stockholders are entitled to dividends paid out by the subsidiaries issuing the tracking stock. Yet the holders of tracking stocks do not have ownership in the company, instead, at-times tracking stock shareholders vote on issues affecting the corporate parent, not the subsidiary whose stocks they own. Another downside is the fact that the board of directors of the tracking-stock subsidiary is often put in place by the parent company and is not elected by tracking stock shareholders, which would cause conflicts of interests.

The tracking stocks are highly skeptical also. Shareholders have limited voting rights, if any, and they cannot elect their own boards. Moreover, if the parent company falls on hard times, conflict could develop between the shareholders of a tracked division, especially if it continues to do well, and the shareholders of the parent company. The potential for such conflict could affect the performance of the tracking stock.

Another important drawback with tracking stock is that it can dramatically increase the potential for conflict and litigation over accounting policy. It is because the owners of the tracking stock have rights only over dividends, and dividend payouts are driven by the recognition of divisional profits, the arguments over profit

recognition are almost sure to arise whenever tracking stock investors are disappointed in their returns. They will surely be tempted to accuse corporate management of adopting policies that deliberately understate their profits.

MARKET PARTICIPANTS AND INVESTORS IDENTIFICATION NUMBER (MAPIN)

Convergence of identity in India continues to be a dream. Several bodies in the past have gone ahead and issued multiple and independent IDs, without any integration, and many more are in the offing. Even in the capital market, two efforts have been made in the past to allot an ID to the investors -DP Client ID and UCC (which is in addition to the folio numbers assigned to investors by mutual funds and by companies). However, for a variety of reasons, an investor was permitted to obtain multiple IDs both times -while he could obtain multiple IDs from a particular depository and also from the second depository, he could obtain multiple UCCs with different brokers of an exchange or across multiple exchanges. A unique ID for investors was once again considered essential and MAPIN was conceived.

The Central Database of Securities Market Participants' and Investors' Identification Numbers (MAPIN) was set up by SEBI under the SEBI (Central Database of Market Participants) Regulations, 2003 and was notified by SEBI on November 20, 2003.

Objectives of MAPIN

The main objectives of MAPIN are :

- (a) To create a unique non-duplicable ID for all investors in order to establish an audit trail for any specific transaction.
- (b) To cover public disclosure of actions taken by SEBI against entities/individuals.
- (c) To develop an inventory of all market participants (issuers/intermediaries/investors).

However, there exists confusion regarding many aspects of usage/applicability of MAPIN and in order to address various issues and concerns, SEBI set up a Committee under the Chairmanship of Shri Jagdish Capoor, Former Deputy Governor of RBI and Chairman of HDFC Bank Ltd. The Report of the Committee was put up for public comments on SEBI Website and SEBI also suspended all fresh registration for UIN from July 1, 2005 following the Committee recommendation seeking to move away from the biometric system for generating UINs. The Report of the Committee to

Examine Issues Relating To MAPIN has rightly recognised that the convergence of identity in India continues to be a dream. Presently, there are multiple and independent IDs issued by several bodies for different purposes like PAN Card, Voter ID Card etc. It is, therefore believed that it would be in the public interest to integrate all such IDs for creating a truly unique multipurpose identification number. This will save on the national resources and be also userfriendly and convenient. It is, therefore desired that a Multipurpose Single Unique Identification Number on the lines of the Social Security Number system prevalent in the US may be introduced. Thus, Instead of creating a new number system, the possibilities of enlarging the scope of PAN and converting that into a universal identification number may be explored. As it requires tremendous efforts and coordination among the regulatory authorities, it may not be possible to achieve this in the short run, however this should be goal that should be set up in the larger public interest.

V. DEVELOPMENTS IN CORPORATE GOVERNANCE

With a view to strengthen the Corporate Governance, SEBI constituted a Committee on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla. The Committee in its report observed that "the strong Corporate Governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure."

Based on the recommendations of the Committee, the SEBI had specified principles of Corporate Governance and introduced a new clause 49 in the Listing agreement of the Stock Exchanges in the year 2000. These principles of Corporate Governance were made applicable in a phased manner and all the listed companies with the paid up capital of Rs 3 crores and above or net worth of Rs 25 crores or more at any time in the history of the company, were covered.

SEBI, as part of its endeavour to continuously improve the standards of corporate governance in line with the needs of a dynamic market, constituted another Committee on Corporate Governance under the Chairmanship of Shri N. R. Narayana Murthy to review the performance of Corporate Governance and to determine the role of companies in responding to rumour and other price sensitive information circulating in the

market in order to enhance the transparency and integrity of the market. The Committee in its Report observed that “the effectiveness of a system of Corporate Governance cannot be legislated by law, nor can any system of Corporate Governance be static. In a dynamic environment, system of Corporate Governance need to be continually evolved.”

Based on the recommendations of the Committee and also with a view to promote and raise the standards of Corporate Governance, SEBI revised clause 49 of the Listing agreement vide its circular dated August 26, 2003, the implementation of which was deferred later. The Securities and Exchange Board of India on October 29, 2004 again revised the Clause 49 of the Listing Agreement.

The provisions of the revised Clause 49 were required to be implemented as per the schedule of implementation given below:

- (a) For entities seeking listing for the first time, at the time of seeking in-principle approval for such listing.
- (b) For existing listed entities which were required to comply with Clause 49 which is being revised i.e. those having a paid up share capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company, by April 1, 2005.

Companies complying with the provisions of the existing Clause 49 (issued vide circulars dated 21st February, 2000, 9th March 2000, 12th September 2000, 22nd January, 2001, 16th March 2001 and 31st December 2001) shall continue to do so till the revised Clause 49 of the Listing Agreement is complied with or till March 31, 2005, whichever is earlier.

However, noticing that a large number of companies are still not in the state of preparedness to be fully compliant with the requirements of revised clause 49 of the listing agreement, SEBI allowed more time to the corporates to conform to clause 49 of the listing agreement and extended the date for ensuring compliance with the revised clause 49 of the listing agreement to December 31, 2005. The major highlights of revised clause 49 are given below :

Definition of Independent Director

The clause defines the ‘Independent director’ as to mean non-executive director of the company, who apart from receiving director’s remuneration, does not have any material pecuniary relationships or transactions

with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect the independence of the director; is not related to promoters or persons occupying management positions at the board level or at one level below the board; has not been an executive of the company in the immediately preceding three financial years; is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the the statutory audit firm or the internal audit firm that is associated with the company; the legal firm(s) and consulting firm(s) that have a material association with the company; Is not a material supplier, service provider or customer or a lessor or lessee of the company which may affect the independence of the director; and is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.

Nominee Directors to be treated as Independent Director

The revised clause provides that Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be independent directors.

Non executive directors’ compensation and disclosures

The new clause provides that all fees/compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and require previous approval of shareholders in general meeting.

Limits on Membership of Committees

For the purpose of considering the limit of the committees on which a director can serve, Chairmanship/membership of the Audit Committee and the Shareholders’ Grievance Committee alone are to be considered.

Declaration to be signed by CEO

The revised clause states that all Board members and senior management personnel shall affirm compliance with the code on an annual basis and the Annual Report of the company shall contain a declaration to this effect signed by the CEO.

Audit Committee

- (i) The requirement of giving terms of reference of the Audit Committee is a must.

- (ii) There is no requirement that all members of the Audit Committee shall be non-executive directors.
 - (iii) Two Third of the members of audit committee shall be independent directors.
 - (iv) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
 - (v) The term "financially literate" has been defined to mean the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.
 - (vi) There is requirement of holding atleast four meetings in a year. The revised clause also provides that not more than four months shall elapse between the two meetings of audit committee.
- company and its subsidiaries in the immediately preceding accounting year.
- (vi) The term "significant transaction or arrangement" has been defined to mean any individual transaction or arrangement that exceeds or is likely to exceed 10% of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year.
 - (vii) Where a listed holding company has a listed subsidiary which is itself a holding company, the above provisions also apply to the listed subsidiary insofar as its subsidiaries are concerned.

The role of the audit committee has also been specified and the information which has been required to be mandatorily reviewed by the Audit Committee has been specified.

Subsidiary Company

- (i) At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of material non-listed Indian subsidiary company.
- (ii) The Audit Committee of the listed holding company shall also review the financial statements, in particular the investments made by the unlisted subsidiary company.
- (iii) The minutes of the Board meetings of the unlisted subsidiary company is required to be placed at the Board meeting of the listed holding company.
- (iv) The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.
- (v) The term "material non-listed Indian subsidiary" has been defined to mean an unlisted subsidiary, incorporated in India, whose turnover or net worth (i.e. paid up capital and free reserves) exceeds 20% of the consolidated turnover or net worth respectively, of the listed holding

Related Party Transactions

- (i) A statement in summary form of transactions with related parties in the ordinary course of business is required to be placed periodically before the Audit Committee.
- (ii) Details of material individual transactions with related parties which are not in the normal course of business are also required to be placed before the audit committee.
- (iii) Details of material individual transactions with related parties or others, which are not on an arm's length basis should be placed before the audit committee, together with Management's justification for the same.

Disclosures

The following disclosures are required to be made under the revised clause:

- (i) Basis of Related Party Transactions
- (ii) Disclosure of Accounting Treatment
- (iii) Risk Management
- (iv) Proceeds from Public Issues, Rights Issues, Preferential Issues etc.
- (v) Remuneration of Directors
- (vi) Management
- (vii) Shareholders.

CEO/CFO Certification

The CEO, i.e. the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO i.e. the whole-time Finance Director or any

other person heading and discharging the finance function shall certify to the Board that:

- (a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief: these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading; these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.
- (b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.
- (c) They accept responsibility for establishing and maintaining internal controls and that they have evaluated the effectiveness of the internal control systems of the company and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.
- (d) They have indicated to the auditors and the Audit Committee significant changes in internal control during the year; significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system.

Report on Corporate Governance

The companies are required to submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the prescribed format. The report is required to be signed either by the Compliance Officer or the Chief Executive Officer of the company.

Compliance Certificate

The revised clause provides that the company shall obtain a certificate from either the auditors or practising Company Secretaries regarding compliance of conditions

of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.

Non-Mandatory Requirements

The clause also prescribes non-mandatory requirements relating to the tenure of independent directors, Remuneration Committee, Shareholder Rights, Audit qualifications, Training of Board Members, Mechanism for evaluating non-executive Board Members and Whistle Blower Policy.

INDIAN HOUSEHOLD INVESTORS' SURVEY 2004

Indian Household Investors' Survey 2004 sponsored by Investor Education and Protection fund, Ministry of Company Affairs was conducted by Society for Capital Market Research & Development, New Delhi. A summary of the major highlights of the survey is given below :

1. The price validity, price manipulation and corporate mismanagement/fraud have persistently been the top three worries of household investors in India.
2. Price volatility and manipulation are the cause of worry for as many as 50% of the respondent.
3. In respect of investors' perceptions about Corporate Governance, the number of households who have trust in company management is far less than these who have no trust. This is so in every income-class and every age-class.
4. More than 50% of the respondents were positive about the current efforts being made to improve Corporate Governance.
5. 38% of the respondents were shareholders of delisted companies. Of these 38%, 80% complained that share are unsalable; 60% complained that share value had been destroyed; 53% complained that these companies do not pay dividend; and 63% said that these companies do not send annual reports.
6. In respect of retail investors' share portfolio practices, the share portfolio diversification by retail investors' lies in the narrow range of 3-10 companies' shares. 20% had only one or two companies in their portfolio. However, roughly about 50% held 3-10 companies in

their portfolio. About one-sixth of total sample household held shares of 11-20 companies and about one-eighth held shares in more than 20 companies.

7. The middle and upper middle class household are a conservative lot. The pre-dominance of long-term investors is significantly more in the higher income and higher age category.
8. Less than 20% intend to held shares for a few days only. About one third intend to hold shares for some months but not exceeding one year.
9. The share owning householder were nearly 74% in the lowest income class (upto Rs.10,000 per month) 58% in the highest income class (above Rs.25000 per month).
10. The number of shareholders having a depository account at the end of December 2004 was only a little over 70 lakh.
11. One out of every five respondents mentioned that demat charges are too high. This complaint was mentioned by 24-25% among the elderly shareowners aged 65 years and 16-17% among the young shareholders aged 30 years and below.

CONCLUSION

Though SEBI has done a commendable job and has been recognised globally as an effective regulator, a lot still needs to be done, as is evident from the findings of the survey discussed above. The survey clearly highlights the need for investor education and awareness in India. Investors are the backbone of the securities market and one must look after their interest aggressively which would contribute to their continued support to the securities market. Many investors do not possess adequate expertise/knowledge to take informed investment decisions. Some of them are not aware of the complete risk return profile of the different investments options. Some investors are not fully aware of the precautions they should take while dealing with the market intermediaries and rating in different securities. Most of the investors are unfamiliar with the market mechanism and the practices as well as their rights and obligations. Thus the Global Benchmarking in investor education and awareness hold the key to sustaining their interest in the securities market.

Over 9,000 listed companies will need to comply with the Listing Agreement by 31 December 2005,

which mandates that Independent Directors should constitute 50% of their Boards. An estimate puts the requirement of Independent Directors at over 30,000. There is an increasing realization among listed companies that they should get best professionals as independent directors who should not only add value to their companies but also build confidence among the investors. Therefore another area which requires global benchmarking is the availability of adequate number of quality independent directors to cater to the requirements of thousands of listed companies.

Mere presence of directors who are independent in terms of the provisions of law does not mean that there would be checks and balances. What is to be ensured is that these directors think and act independently, i.e., qualitatively independent. Such qualitative directors independence include the will and ability in terms of knowledge and experience to ask the hard questions required to provide effective oversight and character and integrity in general and especially in dealing with potential conflict of interest situations.

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JURISTIC PERSONALITY – A NOVEL DIMENSION

ARCHANA KAUL*

The question of criminal liability of a juristic person has troubled Legislatures and Judges for long. Though, initially it was supposed that a corporation could not be held liable criminally for offences where *mens rea* was a requisite, the judicial thinking appears to be that the *mens rea* of the person in-charge of the affairs of the corporation, the alter ego, is liable to be extrapolated to the corporation, enabling even an artificial person to be prosecuted for such an offence. At the same time, another question related to the above aspect i.e., whether a corporation could be prosecuted for an offence for which mandatory sentence of imprisonment is provided continued to agitate the minds of the courts and jurists and the law continued to be the old law despite the recommendations of the Law Commission and the difficulties expressed by the superior courts in many decisions.

It may be pointed out that in India, situation has not been free from doubt. This is evident from two Reports of the Law Commission of India which recommended specific amendments in order to get over this difficulty. The Law Commission's recommendations focused on the fact that the law as it exists renders it impossible for a court of law to convict a Corporation where the statute mandates a minimum term of imprisonment plus fine. It would not be open to the court of law to hold that a corporation would be found guilty and sentenced only to a fine for that would be re-writing the statute and exercising a discretion not vested in the court by the statute. It is precisely for that reason that the Law Commission recommended that where the offence is punishable with imprisonment, or with imprisonment and fine, and the offender is Corporation, the court should be empowered to sentence such an offender to fine only. However, these recommendations have not been acted upon.

The position has been set at rest recently by a landmark decision of the Constitutional Bench of the

Supreme Court in *Standard Chartered Bank and Others v. Directorate of Enforcement*, (2005) 4 SCC 530. The majority of the Constitution Bench (3:2) in this case held that there is no immunity to the companies from prosecution merely because the prosecution is in respect of offences for which the punishment prescribed is mandatory imprisonment and fine. The law applies equally to actual and juristic persons. The minority upheld the earlier ruling of the Supreme Court holding that a company not being an actual person could not be prosecuted for offences for which the prescribed punishment was imprisonment and fine.

The issue involved in the case mentioned above, was whether a company, or a corporation, being a juristic person, could be prosecuted for an offence for which mandatory sentence of imprisonment and fine is provided; and when found guilty, whether the court has jurisdiction to impose a sentence of fine only.

Before dwelling on this judgement, it is pertinent to mention briefly the circumstances under which the reference was made to this larger Bench of the Supreme Court. In *ANZ Grindlays Bank Ltd. and Others v. Directorate of Enforcement*, (2004)6 SCC 531 the Supreme Court doubted the correctness of its decision in *Velliappa Textiles Ltd. [(2003)11SCC 405]* and held that the decision in *Velliappa Textiles* case needs reconsideration by a Constitution Bench for an authoritative pronouncement on the subject.

Velliappa was concerned with prosecution for an offence under Sections 276-C, 277 and 278 read with Section 278 –B of the Income Tax Act, 1961. Each of the punishing sections provides that a person found guilty shall be punishable with a mandatory term of imprisonment and fine. The majority in *Velliappa* took the view that since an artificial person like a company could not be physically punished to a term of imprisonment, such a section, which makes it mandatory

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to impose a minimum term of imprisonment, cannot apply to the case of an artificial person. It was further held that where punishment provided is imprisonment and fine, the court cannot impose only a fine.

The majority was of the view that the legislative mandate is to prohibit the courts from deviating from the minimum mandatory punishment prescribed by the statute and that while interpreting a penal statute, if more than one view is possible, the court is obliged to lean in favour of the construction which exempts a citizen from penalty than the one which imposes the penalty. Following the decision in *State of Maharashtra v. Jugamander Lal*, AIR 1966 SC 940, it was held that the expression used is "imprisonment and fine" and the court is bound to award sentence of imprisonment as well as fine and that there is no discretion on the part of the court to impose only a fine and the court cannot interpret the statutory provisions in a way so as to supply a lacuna in a statute.

In ANZ *Grindlays Bank*, an appeal was filed in the Supreme Court against the decision of the Division Bench of the Bombay High Court contending that no criminal proceedings can be initiated against the appellant company for the offence under Section 56(1) of the Foreign Exchange Regulation Act (FERA), 1973, (hereinafter called as Act) as the minimum punishment prescribed under Section 56(1) (i) is imprisonment for a term which shall not be less than six months and with fine.

In this case the Company an "authorized dealer" within the meaning of Section 2(b) of the Act was indisputably required to comply with the statutory requirements contained in Sections 8, 9 and 49 of the FERA Act read with Chapter X of the RBI Manual. The authorized dealer contravened the provisions of the Act.

The appellants raised several contentions in support of the appeal. One of them being that having regard to the fact that as the offence is said to have been committed by a company; and as in terms of Section 56 of the Foreign Exchange Regulation Act, 1973, the punishment of mandatory imprisonment has to be imposed; no criminal proceedings can be initiated against the company and in that view of the matter, the company as well as the person referred to in sub-sections (1) and (2) of Section 68 thereof cannot be proceeded with. In support of the said contention reliance was placed on the decision of this Court in *Asstt. Commissioner v. Velliappa Textiles Ltd.* (discussed above).

The Supreme Court *prima facie* did not agree with the ratio laid down in *Velliappa Textiles*. It held that the

contraventions of the provisions of the Act having allegedly taken place at the hands of the authorized dealer, and, thus, although it is a company it is liable to be proceeded against. Section 56 of the Act provides for different punishments for commission of different offences. It is true that in an offence of this nature, a mandatory punishment has been provided for but offences falling under other part of the said section do not call for mandatory imprisonment. Section 56 of the Act covers both cases where an offender can be punished with imprisonment or fine and a mandatory provision of imprisonment and fine. In the event it is held that a case involving graver offence allegedly committed by a company and consequently, the persons who are in charge of the affairs of the company as also the other persons, cannot be proceeded against, only because the company cannot be sentenced to imprisonment, in our opinion, the same would not only lead to reverse discrimination but also go against the legislative intent. The intention of Parliament is to identify the offender and bring him to book.

The court should take recourse to such principles of interpretation of statute as may be necessary to make the statute workable keeping in view the doctrine of *ut res magis valeat quam pereat* (rule of reasonable construction).

While taking recourse to the principle of purposive construction, the Supreme Court relied on its decision in *Balram Kumawat v. Union of India*, (2003)7 SCC 628 and pointed out that an attempt should be made to make Section 56 of the Act workable. It is possible to read down the provisions of Section 56 to the effect that when a company is tried for commission of an offence under the Act, a judgement of conviction may be passed against it, but having regard to the fact that it is a juristic person, no punishment of mandatory imprisonment can be imposed. Furthermore, even if the company cannot be punished, the same may not mean that the other persons referred to under sub-sections (1) and (2) of Section 68 cannot also be punished.

Accordingly the Supreme Court held that the correctness of the decision of this Court in *Velliappa Textiles Ltd.*, requires reconsideration by a Constitution Bench, and thus the matters are referred to a Constitution Bench for an authoritative pronouncement on the subject.

The appellants in *Standard Chartered Bank* put forth the following arguments:

1. A company cannot be prosecuted for an offence for which the mandatory sentence is imprisonment.

2. Where an accused is found guilty and the punishment to be imposed is imprisonment and fine, whether the court has got the discretion to impose the sentence of fine alone.
3. When the section commands the punishment for imprisonment and fine, the court is not left with any discretionary power to alter the sentence as that would amount to rewriting the provisions of the law.
4. The penal provision in the statute is to be strictly construed.
5. When an offence is punishable with imprisonment and fine, the court is not left with any discretion to impose any one of them and consequently the company being a juristic person cannot be prosecuted for the offence for which custodial sentence is the mandatory punishment.
1. While arguing that *a company or a corporate body could not be prosecuted for offences for which the sentence of imprisonment is a mandatory punishment*, the appellants seriously assailed the view expressed by the Apex Court in *Asstt. Commr. v. Velliappa Textiles Ltd.* While considering the above argument advanced by the appellants, the Supreme Court observed that there is no dispute that a company is liable to be prosecuted and punished for criminal offences. Although there are earlier authorities to the effect that corporations cannot commit a crime, the generally accepted modern rule is that except for such crimes as a corporation is held incapable of committing by reason of the fact that they involve personal malicious intent, a corporation may be subject to indictment or other criminal process, although the criminal act is committed through its agents.

The Court pointed out that as in the case of torts, the general rule prevails that the corporation may be criminally liable for the acts of an officer or agent, assumed to be done by him when exercising authorized powers, and without proof that his act was expressly authorized or approved by the corporation. In the statutes defining crimes, the prohibition is frequently directed against any "person" who commits the prohibited act, and in many statutes the term "person" is defined. Even if the person is not specifically defined, it necessarily includes a corporation. It is usually construed to include a corporation so as to bring

it within the prohibition of the statute and subject it to punishment. In most of the statutes, the word "person" is defined to include a corporation.

On amenability of the corporation to prosecution, the Court observed that mostly all criminal and quasi-criminal offences are creatures of statute. The amenability of the corporation to prosecution necessarily depends upon the terminology employed in the statute. In the case of strict liability, the terminology employed by the legislature is such as to reveal an intent that guilt shall not be predicated upon the automatic breach of the statute but on the establishment of the *actus reus*, subject to the defence of due diligence. The law is primarily based on the terms of the statutes. In the case of absolute liability where the legislature by the clearest intendment establishes an offence where liability arises instantly upon the breach of the statutory prohibition, no particular state of mind is a prerequisite to guilt. Corporations and individual persons stand on the same footing in the face of such a statutory offence. It is a case of automatic primary responsibility. Therefore, as regards corporate criminal liability, there is no doubt that a corporation or company could be prosecuted for any offence punishable under law, whether it is coming under the strict liability or under absolute liability.

2. *Whether the court has got the discretion to impose the sentence of fine alone where an accused is found guilty and the punishment to be imposed is imprisonment and fine*, it was contended by one of the appellants that if a corporate body is found guilty of the offence committed, the court, though bound to impose the sentence prescribed under law, has the discretion to impose the sentence of imprisonment or fine as in the case of a company or corporate body the sentence of imprisonment cannot be imposed on it and as the law never compels to do anything which is impossible, the court has to follow the alternative and impose the sentence of fine. This discretion could be exercised only in respect of juristic persons and not in respect of natural persons. It was contended that by doing so, the court does not alter the provisions of the law by interpretation, but only carries out the mandate of the legislature. The other appellants contended that the majority decision

in *Velliappa Textiles* has correctly laid down the law. They argued that the Parliament enacted laws knowing fully well that the company cannot be subjected to custodial sentence and therefore the legislative intention is not to prosecute the companies or corporate bodies and when the sentence prescribed cannot be imposed, the very prosecution itself is futile and meaningless.

Various decisions were cited before the Apex Court on the point. However, no unanimous view has been expressed on this question. Different High courts have taken different views on this point. [See *State of Maharashtra v. Syndicate transport co.(P) Ltd.*, AIR 1964 Bom. 195; *Kusum Products Ltd. v. S.K. Sinha* (1980) 126 ITR 804 (Cal); *Badshah v. ITO*(1987) 168 ITR 332 (Ker); *P.V.Pai v. R.L. Rinawma*, (1993)77 Comp Cas 179 (Kant)].

In order to conceive a clearer language for couching such command, the Supreme Court referred to its decision in *State of Maharashtra v. Jugamander Lal*, AIR 1966 SC 940. This was a case where the accused was found guilty under Section 3(1) of the Suppression of Immoral Traffic in Women and Girls Act, 1956. Under this section, any person found guilty shall be punishable on his first conviction with rigorous imprisonment for a term of not less than one year and not more than three years and also with fine extending up to two thousand rupees. The High Court took the view that the word punishable used in the Section postulated a discretion on the court to impose a sentence of imprisonment or a sentence of fine or both.

But this Court held that in the context in which the word 'punishable' has been used in Section 3(1), it is impossible to construe it as giving any discretion to the court in the matter of determining the nature of sentence to be passed in respect of a contravention of the provision. By using the expression 'shall be punishable' the legislature has made it clear that the offender shall not escape the penal consequences. What the consequences are to be, are then specified in the provision and they are rigorous imprisonment for a period not less than one year and not more than three years. And also a fine which may extend to Rs. 2000. These are the punishments with respect to a first offence and higher punishments are

prescribed in respect of a subsequent offence. By saying that a person convicted of the offence shall be sentenced to imprisonment of not less than one year, the legislature has made it clear that the command is to award a sentence of imprisonment in every case of conviction. It is difficult to conceive of clearer language for couching such command.

3. Relying on the above decision, the appellant contended that *when the section commands the punishment for imprisonment and fine, the court is not left with any discretionary power to alter the sentence and that would amount to rewriting the provisions of the law.*

Reference was made to the contrary decisions that have been rendered on this point. [See *Municipal Corporation of Delhi v. J.B. Bottling Co. (P) Ltd.*, 1975 Cri LJ 1148 (DeL); *Oswal Vanaspati & Allied Industries v. State of U.P* (1993) 1 Comp LJ 172.]

Reference was also made to a decision of the US Supreme Court in *United States v. Union Supply Co.*, 215 US 50 (1909), where Justice Holmes observed:

"... And if we free our minds from the notion that criminal statutes must be construed by some artificial and conventional rule, the natural inference, when a statute prescribes two independent penalties, is that it means to inflict them so far as it can, and that, if one of them is impossible, it does not mean, on that account, to let the defendant escape."

In this case there was an indictment of a corporation for willfully violating the sixth section of the Act of Congress of 1902 and any person who wilfully violates any of the provisions of this section shall, for each such offence, be liable to be punished with fine not less than fifty dollars and not exceeding five hundred dollars, and imprisonment for not less than 30 days, nor more than six months. It is interesting to note that for the offence under Section 5, the court had discretionary power to punish by either fine or imprisonment, whereas under Section 6 both punishments were to be imposed in all cases. The plea of the company was rejected.

4. The next contention of the appellant was that *the penal provision in the statute is to be strictly*

construed. In support of this contention, reliance was placed on *Tolaram Relumal v. State of Bombay*, 1954 Cri L J 1333 and *Girdhari Lal Gupta v. D.H. Mehta*, (1971)3 SCC 189.

Agreeing with the contention raised by the appellants, the Court emphasized that the penal provisions have to be construed as per the legislative intent as expressed in the enactment. The Supreme Court stated that it is true that all penal statutes are to be strictly construed in the sense that the court must see that the thing charged as an offence is within the plain meaning of the words used and must not strain the words on any notion that there has been a slip that the thing is so clearly within the mischief that it must have intended to be included and would have been included if thought of. All penal provisions like all other statutes are to be fairly construed according to the legislative intent as expressed in the enactment. Here, the legislative intent to prosecute corporate bodies for the offence committed by them is clear and explicit and the statute never intended to exonerate them from being prosecuted. It is sheer violence to common sense that the legislature intended to punish the corporate bodies for minor and silly offences and extended immunity of prosecution to major and grave economic crimes.

In modern times the distinction between a strict construction and a more free one has disappeared and now mostly the question is "what is true construction of the statute?" In this context the Apex Court relied on a passage in *Craies on Statute Law, 7th Edn.* which reads as under:

"The distinction between a strict and a liberal construction has almost disappeared with regard to all statutes, whether penal or not, are now construed by substantially the same rules. "All modern Acts are framed with regard to equitable as well as legal principles."

Citing the *Lyons Case (169 ER 1158)* where hundred years back court said "statutes were required to be perfectly precise and resort was not had to a reasonable construction of the Act, and thereby criminals were often allowed to escape. This is not the present mode of construing Acts of Parliament. They are construed now with reference to the true meaning and real intention of the legislature."

What is the intention of the legislature, the Court held that it is an undisputed fact that for all the statutory offences, company also could be prosecuted as the "person" defined in these Acts includes "company, or corporation or other incorporated body."

5. Another argument was *when an offence is punishable with imprisonment and fine, the court is not left with any discretion to impose any one of them and consequently the company being a juristic person cannot be prosecuted for the offence for which custodial sentence is the mandatory punishment.*

The Court held that this plea is acceptable if the custodial sentence is the only punishment prescribed for the offence (i.e., the company being a juristic person cannot be prosecuted for the offence for which custodial sentence is the mandatory punishment). But when the custodial sentence and fine are the prescribed mode of punishment, the court can impose the sentence of fine on a company which is found guilty as the sentence of imprisonment is impossible to be carried out. It is an acceptable legal maxim that law does not compel a man to do that which cannot possibly be performed (*impotentia excusat legem*). So also "if an enactment requires what is legally impossible it will be presumed that Parliament intended it to be modified so as to remove the impossibility element". As the company cannot be sentenced to imprisonment, the court cannot impose that punishment, but when imprisonment and fine is the prescribed punishment, the court can impose the punishment of fine which could be enforced against the company. Such discretion is to be read into the section so far as the juristic person is concerned.

In fact, there are a series of offences under various statutes where the accused are also liable to be punished with custodial sentence and fine. As per the scheme of various enactments and also the Penal Code, mandatory custodial sentence is prescribed for graver offences. If the appellants' plea is accepted, no company or corporate bodies could be prosecuted for the graver offences whereas they could be prosecuted for minor offences as the sentence prescribed therein is custodial sentence or fine. It could not be the intention

of the legislature to give complete immunity from prosecution to the corporate bodies for the grave offences. The offences mentioned under Section 56(1) of the FERA Act, 1973, for which the minimum sentence of six months' imprisonment is prescribed, are serious offences and if committed would have serious financial consequences affecting the economy of the country. All those offences could be committed by company or corporate bodies. The legislative intent cannot be not to prosecute the companies for these serious offences, if these offences involve the amount or value of more than Rs. one lakh, and that they could be prosecuted only when the offences involve an amount or value less than Rs. one lakh.

The Apex Court held : There is no blanket immunity for any company from any prosecution for serious offences merely because the prosecution would ultimately entail a sentence of mandatory imprisonment. The corporate bodies, such as a firm or company undertake a series of activities that affect the life, liberty and property of the citizens. Large-scale financial irregularities are done by various corporations. The corporate vehicle now occupies such a large portion of the industrial, commercial and sociological sectors that amenability of the corporation to a criminal law is essential to have a peaceful society with stable economy.

It was further held that there is no immunity to the companies from prosecution merely because the prosecution is in respect of offences for which the punishment prescribed is mandatory imprisonment and fine. The views expressed by the majority in *Velliappa Textiles* were overruled on this point.

Conclusion

The decision of the House of Lords in *Salomon v. Salomon & Co, Ltd (1897) A.C.22* recognizing the principal of separate legal entity has had lasting influence on the development of modern company law. This more than one hundred year old decision articulated the

founding propositions of company law and is accordingly treated with reverence by academics and practitioners alike. Since then many developments have taken place in the realm of company law. That apart, the global economic environment has further pushed the frontiers of the corporate sector thereby enhancing their responsibilities and accountability. The decision of the Supreme Court is welcome. The corporate vehicle as rightly observed by the Apex Court now occupies such a large portion of the industrial, commercial and sociological sectors that amenability of the corporation to a criminal law is essential to have a peaceful society with stable economy. Mention should be made that the judiciary in India has not been a salient spectator to the changes that are taking place. In fact, it has been a creative organ actively involved in interpreting the provisions of the law to ascertain the true intention of Parliament in enacting the statute and as far as possible to advance such legislative intent.

There are several statutes making corporations and companies liable for conviction which prescribe punishment by way of imprisonment and fine. In fact the second offence is taken more seriously and that is why punishment of imprisonment has been made mandatory. It can 't be said that for first offence a corporation can be prosecuted and punished while in the case of second offence it goes scot-free because imprisonment is a mandatory sentence in that case. For difficulty in sentencing offenders need not escape prosecution. It may be pointed out that while laying down criminal liability the statute does not make any distinction between a natural person and corporations. Allowing corporations to escape liability for prosecution on this specious plea based on difficulty in sentencing, will be doing violence to the statute. Any interpretation which leads to results contrary to the statutory mandate will be in violation of the statute. Merely because there is no specific mention in the section of the statute that in the event of breach committed by the companies and corporations, the punishment can only be in the nature of fine is no ground to read into the provision a fatal lacuna. The provision, which is clearly applicable equally to natural and juristic persons, if construed reasonably would be found workable and capable of fulfilling the object of the Act.

CROSS BORDER CONSUMPTION TAXATION UNDER VAT REGIME – A NEW AREA OF SPECIALIZATION FOR PROFESSIONALS

YOGINDU KHAJURIA*

INTRODUCTION

Many organisations feel that they lack control over subsidiary tax compliance affairs. This situation becomes more complex in the light of focus on good tax governance and compliance. The approach of tax specialists fits well with groups seeking better tax governance and tax management across a number of territories or with multiple entities in one territory. This is particularly so where corporates are entering new countries or where accounting and finance resources are being moved into shared service centres. The specialists can provide quality technical support including: coordination of multi country compliance requirements; corporate tax return preparation; compliance support with other taxes (eg. State and local taxes); tax payment advice; tax compliance time limit monitoring; tax compliance outsourcing services; tax compliance process improvement; and integration with local country statutory accounting compliance services.

NEED OF SPECIALIST SERVICES

Need of tax-efficient international assignment structures and policies is a must. The ability of professional specialists to operate profitably in diverse geographic markets, and to shift operations flexibly between countries results as an essential to the success of the business. But operating globally generates a wide variety of practical, legal, HR and finance issues. Multinational firm has to comply with host countries' laws on tax, pensions, business practices and human resources. One country's entrepreneur may be another's antitrust violator.

With the increasing focus on governance and regulation, tax compliance has never been so important.

Cross-border transactions need to manage multi-territory compliance requirements and keep abreast of changes in local legislation in each country that affect these requirements, while often facing additional pressures such as a lack of resources and the need to control costs and reduction of taxes. Multinational businesses are increasingly affected by tax, legislative and regulatory developments throughout the world. Understanding the impact of these developments on business operations and transactions between countries is vital for a company's survival. Professional specialists can help in managing global tax compliance issues, risks and opportunities. Having a strong international network of tax practitioners, they provide a consistently high quality service, coordinated across as many territories as possible.

The network of professionals in international tax structuring can help in greater tax governance by addressing latest developments as well as all aspects of cross-border taxation. They are well equipped and can structure cross border businesses in a tax-efficient manner, besides local managing by constructing effective cross-border strategies and managing global structural tax rate. Being enriched in knowledge and abreast of new developments in the international arena that affect international business, the professional specialists can advise on various issues like:

- foreign companies tax planning;
- income tax treaties;
- tax efficient holding company locations;
- cross-border financing and treasury solutions;

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B A C K G R O U N D E R

- tax efficient supply chain and shared services;
- tax harmonization and regional tax issues under VAT etc.

One of the main reasons of tax complexity arises due to a shift of emphasis to consider both forms of potential double taxation together.

CROSS-BORDER TAXATION

The term, “cross-border taxation” means taxation in more than one country. In the international scenario, analysis of corporate taxation is very complex. This tax complexity arises due to a number of reasons. The prominent three reasons are:

1. Ways of Cross-border Investment;
2. Issues of Double Taxation involved;
3. Involvement of Minimum two Countries.

1. Ways of Cross-border Investments

Various ways in which cross-border investments can be made are:

- (a) Investment by an individual in a domestic company which further invests in a foreign business i.e., permanent establishment;
- (b) Investment by an individual in a foreign company which further invests in a business in its own country;
- (c) Investment by an individual in a domestic company which invests in a foreign company, which further invests in a business unit in its own country.

The main taxation issue in the above alternatives is, whether or not income derived through a company is taxed in the same way as income derived directly by an individual. In order to resolve the above issue, one generally tends to assume that an individual investment in a company is portfolio e.g., small shareholding in a listed company. Second assumption is that the investment by a corporate resident in one country in corporate resident in another country is direct investment. Investment in the business by the company is also assumed as one form of direct investment through a branch. In multinational companies, there is different set up. In general, above three types represents tax compliance in vast majority of cross-border investments through companies. The main concern in all the above is international double taxation.

2. Issues of Double Taxation Involved

The issues involved in double taxation include: double taxation of company shareholder income and international double taxation. The term international double taxation means taxation in more than one country.

India has been acknowledged as sovereign republic in the preamble to the Constitution of India. Under Entry 14 of the Union List, the matter relating to “Entering into treaties and agreements with foreign countries and implementing of treaties agreements and conventions with foreign countries” have been included. Thus, the exclusive power of the Parliament to make laws with regard to entering into treaties and agreements is all encompassing and consequently, includes the power to legislate in this regard in the field of taxation of income.

This special power has been exercised by the Parliament by enacting Section 90 of the Income Tax Act, 1961. As per this Section, the Central Government has been empowered to enter into agreements with foreign countries for granting reliefs in respect of avoidance of double taxation so as to promote mutual economic relations, trade and investment. Central government has been empowered not only to enter into agreements for the avoidance of double taxation but also for exempting income from taxation. The effect of entering into these agreements provide that if no tax liability is imposed under the Act, then the question of resorting to the agreement would not arise. Where tax liability is imposed then the agreement may be resorted to for negating or reducing it. However, in case of difference between the provisions of the Act and of the agreement, the provisions of the agreement shall prevail over the provisions of the Act to the extent they are beneficial to the subject and shall be enforceable by the appellate authorities and the Court.

3. Involvement of Minimum Two Countries

There is a requirement of a minimum two countries as there is a possibility that the countries apply different tax systems and there is no uniformity among various tax systems. Thus, it becomes difficult as to which country's tax system should effectively govern. There arises a necessity of having two perspectives that is one of the source country of the company and second that of the residence country to see how it relieves international double taxation. Such reliefs can be provided either by granting relief from corporate double taxation or by extending any such domestic relief to the international sphere. In the source country, the outcome shall depend upon how it taxes non-residents. The current international tax system as implemented in tax treaties is premised on the basis that the source country

can generally tax the company's income from the business carried on in that country in the same way as it taxes resident locally owned companies. The exception to this is most of the branch income of shipping and airline companies, which are not taxable in the country of the branch. In respect of the business carried out in the branch, the source country is obliged by the business profits article of tax treaties to apply corporate tax on a net basis. The source country is bound to follow tax treaties in respect of business branch or subsidiary form so as to eliminate discrimination against the non-resident owners and to apply the arm's length principle in determining the allocation of income between the source country and the residence countries because this system is entrenched by treaties.

CONSUMPTION TAXATION

The growing interest in consumption taxation can be explained by the substantial increase in international trade and cross border services during the last decade and by the new phenomenon of electronic commerce, both business to business and business to consumer. Consumption taxation has from early times when a part of goods sold by merchants had to be given to the rulers of the community where commerce was generally done. In 1900 BC, Assyrian caravans paid 2.9 per cent of the value of textile and tin upon exportation of these goods to neighboring States. In European countries sales taxes in spite of being an important source of revenue for local and national governments, lost favour in the 18th and 19th centuries, when the doctrine of ability to pay caused a shift toward taxing income and wealth. In Western Europe, the sales tax became unimportant in the beginning of the 20th century. A large number of countries introduced general sales taxes despite of great opposition after the economic crises of the 1930s as a temporary measure and after the World War II, their rates increased substantially.

In 1960s, sales or turnover taxes developed into consumption taxes in Europe. After a span of around three years after the foundation of the European Economic Community (1957), study group of the European Commission came to the conclusion that the classical system of sales taxes or turnover taxes, a cumulative system of taxes in almost all stages of production distribution, should be converted into a credit invoice method VAT (Value Added Tax) based on principles of internal and external neutrality. The term, "internal neutrality" meant that the burden of consumption tax shall be proportional to the price paid by the final consumer for goods and services, irrespective of the number of transactions during the previous stages

of the production and distribution process. The basic principle behind "external neutrality" was that the consumption tax in the country of consumption shall bear upon the goods or services and hence the revenues of the consumption tax accrue to the country of consumption. In the year 1967, the Council of EEC adopted the First (67/227/EEC) and Second (67/228/EEC) Directive of VAT containing the basic principles of VAT. The First Directive is still in force and but the Second Directive has been replaced by the Sixth VAT Directive (77/388/EEC), setting the rules for harmonization of the taxable base for the VAT.

The aim of consumption type of VAT is to tax all final consumption expenditures of goods and services so that final consumer bears the VAT charged to him by her supplier. It is leviable at each stage of the production and distribution process and in each stage the supplier of goods and services is liable for VAT.

In cross-border production and distribution chain, the credit invoice method of VAT follows the country of destination principle by applying zero rate tax for such transaction and levying VAT upon importation in the country of destination. In non-Vatable consumption taxes like, sales tax, the cascading effect of sales tax can be mitigated by applying an exemption of sales tax on supplies of goods and services to business customers.

VAT is in force in more than 130 countries ranging from Sri Lanka to China. India too has a VAT at the Central level (CENVAT).

VAT IN OTHER COUNTRIES

It shall not be an exaggeration to say that the emergence of the VAT as an important and elastic source of revenue over the last four decades is unparalleled in the history of taxation. Despite the widespread proclamation of VAT, there have been difficulties in implementing VAT in its true spirit in the countries like, Japan, Colombia, Russia, USA etc. Despite of such difficulties, it can be said with confidence that Value Added Tax system definitely has its advantages and is certainly recommended for most economies, particularly the developing ones.

VAT IN JAPAN

Japanese Ministry of Finance introduced national consumption tax in the year 1970 for the first time. It however took three tries due to massive public opposition which desired to reduce or suspend this consumption tax in order to stimulate the Japanese economy, before finally passing the law. Consumption

tax is a sales tax levied in Japan with main objective to tax consumer expenditure.

This consumption tax was designed in such a manner that it passed on to and is ultimately borne by the final consumer. The levy of this tax was at every stage of production and distribution. This tax used a credit method for intermediary businesses and in actual practice, it was to be added to the price of products sold and services provided by an enterprise. Thus, it provided an additional cost for the individual consumer. The system of consumption taxation in Japan allowed businesses to set off some or all of input tax that it suffers against the output tax collected with only the net amount having to be paid over to the government.

Under Japanese context, a tax payer for consumption tax purposes is an enterprise supplying taxable goods or services in the country above a certain limit for consideration. The term enterprise for the above purposes includes individuals as well as companies resident and foreign corporations.

The consumption tax on taxable purchases during a taxable period is classified into three groups namely, tax on taxable transactions, tax on non-taxable transactions and tax incurred on both taxable transactions and non-taxable transactions in common.

VAT IN COLOMBIA

In Colombia, VAT is an indirect tax and is applicable to sales of goods, services rendered within the national territory and imports of tangible movable assets. It does not apply to the sale of fixed assets except for sales of automobiles and airplanes and of other fixed assets sold in the name and on behalf of third parties.

The general VAT rate in Colombia is 16 per cent. VAT is equivalent to the difference between the tax generated by the taxed transactions and the tax credits that are legally deductible. VAT generated on taxable transactions is established by applying the rate of the tax to the taxable base and deducting VAT on returns and transactions rescinded, resolved or rendered void. VAT paid on the acquisition of goods and services up to the limit resulting from applying to the value of the transaction evidenced by the respective invoices, the tax rate on the activity that is being taxed, the portion exceeding this percentage shall constitute a higher value of the cost or of the respective expenditure.

VAT Credits in respect of acquisitions of goods and services and for imports are available only if it is incurred in respect of transactions, which are allowed as costs or expenses of the enterprise as per income tax laws.

Cross-border services in Colombia are subject to double taxation taking into account the services rendered in the country which are subject to VAT unless the relevant services are documented as exempt exports. So, the cross-border transactions shall be so structured that they amount to export of services in order to be exempt from VAT.

VAT IN GREECE

The principle of neutrality as laid out in article 2 of the Sixth Directive is adopted by the Greek VAT law. In Greece, VAT system was introduced by Law 1642/1986 which implemented the EC Council Directive 77/388/EEC "on harmonization of the laws of the Member States relating to turnover taxes-common system of Value Added Tax: uniform bases of assessment" (Sixth Directive). This law was amended number of times and the latest codification of Greek VAT law was effected by Law 2859/2000.

The method of taxation followed in Greece is credit invoice method besides special schemes introduced by various articles.

The standard fixed for VAT in Greece is eighteen per cent subject to certain exceptional items where reduced rates are made applicable for computing VAT. In the instances where a EU resident makes a taxable supply in Greece, he is required to get registered for VAT purposes through appointment of a representative, who is not a VAT representative and is not co-liable for the payment of VAT. On the contrary, where a non EU resident makes a taxable supply in Greece and does not have a permanent establishment, then he shall be required to get registered for VAT purposes through appointment of a VAT representative who shall be co-liable for the payment of VAT.

There is no concept of forming VAT Groups in Greece allowing Member States to consider and treat as a single taxable person, who are legally independent and are closely bound to one another.

VAT IN SOUTH AFRICA

In South Africa VAT is transaction-based tax. It was introduced in the year 1991 by implementation of Value Added Tax Act No. 89 of 1991. The levy of VAT extends to supply of goods and services by a vendor, who is a person registered for VAT in South Africa. There are two ways in which a person can register as a vendor. First is voluntary and second is compulsory. South African Revenue Services allocates different tax categories to the vendor on obtaining registration on the basis of tax supplies of the vendor during the course of the year ,

which are categories A, B, C, D. Generally, categories A and B are allocated to most of the vendors. In terms of these categories, tax returns are submitted every second month. Where turnover of a vendor exceeds R30 million in one year period, the vendors are required to get registered under category C. In this category, tax returns are submitted on monthly basis. Fourth category is category D which is available to farmers or farming enterprises on a total turnover of less than R1 million per annum. Under this category, the vendors are required to submit VAT returns on half yearly basis.

VAT is leviable on the supply of goods and services. The standard rate of tax in South Africa is 14 per cent. It is levied at each stage of a transaction. In a system of input tax claimable and output tax payable, it is the end consumer who bears the VAT burden. In cases of exempt supplies, the vendor shall not levy VAT on the supply or claim his input tax credit thereon.

VAT IN UNITED KINGDOM

In UK, VAT is based on invoice credit method and follows the European Union model. VAT in UK is a multistage and tax is charged and collected at each stage of the production and distribution cycle. There are two rates of VAT in UK. One is standard rate i.e., 17.5 per cent and another is reduced rate i.e., 5 per cent. It is a self assessed tax and the traders are entitled to certainty in dealing with their tax affairs.

The taxable person in the context of VAT is supplier of goods and services who shall obtain registration for VAT purposes and shall also be liable to pay tax. Refund of VAT is made to the traders on purchases of goods and services and on importations so that the tax is borne by the final consumer. There shall be no refund of tax to the traders if the goods and services are used to make exempt supplies.

The governing legislation in UK is EU Sixth Directive along with the national provisions implementing the directive. There have been numerous changes in the UK rules since the adoption of the Directive for computing relief for input tax for partly exempt traders. The amendments to the legislation have been made to bring harmonization and improvement in the accuracy of the computation of the relief. These regulations provide for a standard method for computing input tax deduction for partly exempt businesses but customs have the power to approve and devise special methods where the value of particular outputs could unfairly distort the computation of the input tax deduction.

UK recognizes registration of groups consisting of single taxable person as two or more companies under

common control. The general effect of grouping is that the supplies of goods and services between the group members are ignored for VAT purposes. One of the members is recognized as representative member who is responsible for all supplies to and by members of a VAT group. This has been done by traders for tax avoidance purposes. Recently, the financial institutions in UK have started using joint venture companies in VAT groups in order to reduce the VAT cost of outsourcing.

VAT IN UNITED STATES

There is no broad-based federal tax on consumption in United States. There exists single stage retail sales taxes in majority of the American States with an exception to two States where modified form of VAT exists that reaches some of the value added by financial institutions operating in that State. There is no border adjustable tax on consumption in U.S. In the year 1971, Congress enacted income tax reliefs for exporters tied to export sales receipts. The law of Domestic International Sales Corporation was modified and renamed over the next thirty years and in 2002, its successor legislation Foreign Sales Corporation Tax was held to be a prohibited subsidy under World Trade Organisation Rules. The report on consumption taxation explored the VAT with limited scope including cross-border transactions. This report does not mention VAT implications for a US company operating in a VAT country which is registered for VAT.

US major trading partners rely on destination principle to tax cross-border transactions. In case of imposition of VAT on cross border transactions under a normative destination principle tax base, there would be imposition on all imports of goods and services to be consumed domestically and all exports would have been free from tax. Thus, none of the forms of VAT in use today are imposed on this normative tax base.

VAT IN RUSSIA

In Russia, there are three main consumption taxes namely, excise tax, sales tax and VAT. Chapter 21 of the Russian Federation Tax Code which came into force on January 2001 regulates the VAT system in Russia by replacing the former federal law on VAT and the related legislative documents. It is a tax levied by the federal government and is payable to the federal budget only.

VAT obligations are determined by credit invoice system. For VAT purposes, the seller of goods and services and not the buyer is considered as a taxpayer. Taxpayers include Russian companies, foreign

companies, private entrepreneurs and small businesses including companies and private entrepreneurs whose gross proceeds net of VAT do not exceed 10 lac roubles.

Standard rate of VAT is 20 per cent, while a reduced rate of 10 per cent is applicable to certain types of goods. Export of goods and services is subject to VAT at a rate of 0 per cent.

VAT IN INDIA

In India, State-level VAT is a multi-point tax on value addition which is collected at different stages of sale with a provision for set-off for tax paid at the previous stages i.e., tax paid on inputs. It is to be levied as a proportion of the value added (i.e. sales minus purchase) which is equivalent to wages plus interest, other costs and profits. It is a tax on the value added and can be aptly defined as one of the ideal forms of consumption taxation since the value added by a firm represents the difference between its receipts and cost of purchased inputs. It is commonly referred to as a method of taxation whereby the tax is levied on the value added at each stage of the production and distribution chain. It intends to tax only the value added at each stage and not the entire invoice value of the product. By ensuring that only the incremental value is taxed, it aims at eliminating the cascading effect of taxes on commodities and reduces the eventual cost to the consumer.

It is one of the most radical reforms, albeit only in the sphere of State level taxes on sale, that have been initiated for the Indian economy after years of political and economic debate aiming at replacing complicated tax structure to do away with fraudulent practices.

With the objective to introduce State-Level VAT in India in the Year 1992, the Government of India constituted a Tax Reform Committee headed by Dr. Raja J. Chelliah. In 1993, the Committee recommended the introduction of VAT in place of existing tax system. Thereafter, the Government appointed NIPFP (National Institute of Public Finance and Policy), New Delhi, as the Nodal Agency to work out the modalities of VAT.

The first preliminary discussion on State-Level VAT took place in a meeting of Chief Ministers convened by Dr. Manmohan Singh, the then Union Finance Minister in 1995. In this meeting, the basic issues on VAT were discussed in general terms and this was followed up by periodic interactions of State Finance Ministers.

For implementing the above decisions, an Empowered Committee of State Finance Ministers was set-up. Thereafter, this Empowered Committee met frequently and got full support from the State Finance

Ministers, the Finance Secretaries and the Commissioners of Commercial Taxes of the State Governments as well as Senior Officials of the Revenue Department of the Ministry of Finance, Government of India. Through repeated discussions and collective efforts of all, it was possible to achieve remarkable success within a period of about one and half years. After reaching this stage, steps were initiated for the systematic preparation for the introduction of State-Level VAT.

Along with these measures ensuring convergence on the basic issues on VAT, steps were taken for necessary training, computerization and interaction with trade and industry, particularly at the State level. This interaction with trade and industry was specially emphasized. The conference of State Chief Ministers presided over by Shri Atal Behari Vajpayee, the then Prime Minister, held on October 18, 2002 at which Shri Jaswant Singh, the then Finance Minister was also present, confirmed the final decision that all the States and the Union Territories would introduce VAT from April 1, 2003.

The Empowered Committee of State Finance Ministers on February 8, 2003 again endorsed the suggestion that all the State legislations on VAT should have a certain minimum set of common features. Most of the States came out with their respective draft legislations. Shri Jaswant Singh the then Union Finance Minister, also announced the introduction of VAT from 1st April, 2003 in his 2003-2004 budget speech made on February 28, 2003. Owing to some unavoidable circumstances, VAT could not be implemented w.e.f. April 1, 2003 and also on the revised date June 1, 2003, Despite all obstacles, Haryana was the first State to implement VAT w.e.f. April 1, 2003. In rest of the States VAT Laws were at draft stage.

The Empowered Committee of the State Finance Ministers constituted by the Ministry of Finance, Government of India, on the basis of the resolution adopted in the conference of the Chief Ministers on November 16, 1999 under the Chairmanship of Dr. Asim Dasgupta came out with a White Paper on State-Level VAT, which was released on January 17, 2005 by Shri P. Chidambaram, The Finance Minister, Government of India. On this occasion, Finance Minister remarked:

“This is the first document which has been collectively prepared and put out to the people of the country by the Finance Ministers of all States.... We have formed the rainbow coalition to undertake one of the biggest tax reforms.”

This Paper consists of three parts. In Part I, justification of VAT and the background has been mentioned. In Part II, main Design of VAT as evolved on the basis of consensus among the States through repeated discussions in the Empowered Committee has been elaborated. In Part III, other related issues for effective implementation of VAT have been discussed.

The White Paper specified that registration under the VAT Act shall not be compulsory for the small dealers with gross annual turnover not exceeding Rs.5 lakh. However, the Empowered Committee of State Finance Ministers has subsequently allowed the States to increase the threshold limit for the small dealers to Rs.10 lakh, but the concerned State shall have to bear the revenue loss, on account of increase in the limit beyond Rs. 5 lakh. The VAT Acts are designed so that high value taxpayers should not be spared and on the contrary small dealers should be hassle free from compliance procedures.

The objective of all such composition schemes is not to burden small dealers by the provisions of record keeping. Therefore, such schemes will generally contain the following features:

- (i) small amount of tax shall be payable;
- (ii) there shall be no requirement to calculate taxable turnover;
- (iii) a simple return form to cover longer return period shall be sufficient.

All sales or purchases of goods made within the State except the exempted goods would be subjected to VAT as a consumption tax.

In his speech introducing Union Budget 2005-06, the Hon'ble Finance Minister said, "In a remarkable display of the spirit of cooperative federalism, the States are poised to undertake the most important tax reform ever attempted in this country. All States have agreed to introduce the value added tax (VAT) with effect from April 1, 2005. VAT is a modern, simple and transparent tax system that will replace the existing sales tax and eliminate the cascading effect of sales tax.

In the medium to long term, it is my goal that the entire production-distribution chain should be covered by a national VAT, or even better, a goods and services tax, encompassing both the Centre and the States.

The Empowered Committee of the State Finance Ministers, with the solid support of the Chief Ministers, has laboured through the last 7 years to arrive at a framework acceptable to all States. The Central

Government has promised its full support and has also agreed to compensate the States, according to an agreed formula, in the event of any revenue loss. I take this opportunity to pay tribute to the Empowered Committee, and wish the States success on the introduction and implementation of VAT".

EXTRACTS FROM KELKAR COMMITTEE REPORT

Considering that the implementation of VAT was closely linked to the administration of other indirect taxes and impacts the tax to GDP ratio, it had become necessary to examine the relevant issues. In this direction the Task Force has had the benefit of meeting with the Empowered Committee of the Finance Ministers of the States, constituted for the purpose of implementing a nationwide State-level VAT. The Empowered Committee experimented on federal fiscal planning and achieved much in terms of building a consensus on many of the critical issues relating to implementation of VAT in a relatively short spell of time. Most countries have taken several years to implement VAT. Decisions were taken on the important features of VAT relating to replacement of the State Tax levied by the States though some other local taxes like octroi, mandi, cess etc. may continue.

It was recommended that a publicity awareness programme shall be started jointly by the Central Government and the State Governments. The Central Government shall extend financial support for this, if needed. Since the State VAT is expected to be implemented from 1.4.2003, it is also necessary that the publicity awareness programme should be implemented at the earliest.

One of the issues which had impact on the transition of VAT was the compensation to be given to the States upon the removal of Sales-tax and the introduction of State VAT, in the event the tax revenue drops due to the change over. In this regard, it had been observed that the experience worldwide has been that a move towards VAT results in higher revenue realization.

During the meetings that the Task Force had with several industry and trade bodies, it was represented that the switch-over to VAT must ensure that the desired benefits are achieved, especially in view of the fact that this switch-over shall entail a major overhaul of systems and procedures for business and governments and at substantial expenditure of money, time and effort.

Under the existing sales-tax structure, there are problems of double taxation of commodities and multiplicity of taxes resulting in a cascading tax burden.

As per the existing structure before a commodity is produced, inputs are first taxed and then after the commodity is produced with input tax load, output is taxed again. This causes an unfair double taxation with cascading effects. In the VAT, a set-off is given for input tax as well as tax paid on previous purchases.

The design of State-level VAT had been worked out by the Empowered Committee through several rounds of discussions and striking a federal balance between the common points of convergence regarding VAT and flexibility for the local characteristics of the States.

Vat Liability

In India, the VAT is based on the value addition to the goods and the related VAT liability of the dealer is calculated by deducting input tax credit from tax collected on sales during the payment period (say, a month).

The White Paper specifies that registration under the VAT Act is not compulsory for the small dealers with gross annual turnover not exceeding Rs.5 lakh. However, the Empowered Committee of State Finance Ministers subsequently allowed the States to increase the threshold limit for the small dealers to Rs.10 lakh, but the concerned States will have to bear the revenue loss on account of increase in the limit beyond Rs.5 lakh.

VAT is so designed that high value taxpayers are not spared and on the contrary small dealers are also hassle free from compliance procedures.

Advantages

Introduction of VAT in India has many advantages i.e.,

- to encourage and result in a better-administered system;
- to eliminate avenues of tax evasion;
- to avoid under valuation at all stages of production and distribution;
- to claim credit of tax paid on inputs at each stage of value-addition;
- do away with cascading effect resulting in non distortion of the business decisions;
- permit easy and effective targeting of tax rates as a result of which the exports can be zero-rated;
- ensures better tax compliance by generating a trail of invoices that supports effective audit and enforcement strategies;

- contribution to fiscal consolidation for the country. As a steady source of revenue, it shall reduce the debt burden in due course;
- to help India to integrate better in the WTO regime;
- to stop the unhealthy tax-rate war and trade diversion among the States, which had adversely affected the interests of all the States in the past.

Methods of Computation

In India, computation of VAT can be done by using any of the following methods namely,

1. *The Subtraction method* : Under this method the tax rate is applied to the difference between the value of output and the cost of input;
2. *The Addition method* : Under this method value added is computed by adding all the payments that are payable to the factors of production (viz., wages, salaries, interest payments etc);
3. *Tax credit method* : Under this method, it entails set-off of the tax paid on inputs from tax collected on sales. Indian States opted for tax credit method, which is similar to CENVAT.

Procedure

In India, VAT is based on the value addition to the goods. Input tax credit is given for both manufacturers and traders for purchase of input or supplies meant for both sales within the State as well as to the other States irrespective of their date of utilization or sale. If the tax credit exceeds the tax payable on sales in a month, the excess credit will be carried over to the end of the next financial year. If there is any excess unadjusted input tax credit at the end of the second year then the same will be eligible for refund. For all exports made out of the country, tax paid within the State is refunded in full. Tax paid on inputs procured from other States through inter-State sale and stock transfer shall not be eligible for credit.

The existing Sales Tax Acts in all States shall give place to the State VAT Act. Accordingly the Rules, Schedules and Forms under the erstwhile Acts shall be abolished. However, Central Sales Tax shall continue to govern inter-State sales and exports.

Rates of Tax

As contrasted to the multiplicity of rates under the existing regime, there are four broad rates under VAT regime -0% (Exempted for unprocessed agricultural

goods, and goods of social importance), 1% for precious and semiprecious metals, 4% for inputs used for manufacturing and on declared goods, capital goods and other essential items, 20% for demerit/luxury goods and the rest of the commodities shall be taxed at a Revenue Neutral Rate of 10-12.5%.

Distinction between Existing System and VAT

Indian States continue to tax declared goods on single point basis under the existing system subject to a rate of 4%. Under VAT, declared goods shall also be subject to tax at multiple levels.

As per existing Sales tax law, inputs used for manufacture, whether capital or otherwise, are eligible for concessional rate of tax on furnishing the requisite forms. However, under the VAT system, there is no place for concessions. Goods are taxed at their respective rates with a provision for set off in future. There is no incentive scheme under VAT, barring those carried forward from the existing system.

Exports and supplies to exporters i.e. penultimate sales are exempt from tax under the existing system subject to certain conditions. Under VAT, exports are zero-rated i.e. they are not exempted, giving rise to refund of tax paid on inputs.

There is no set off of prior taxes paid under the existing system of Single Point Tax and Multi-point tax. In Single point Tax too, further taxation is effected by way of turnover tax and hence set off assumes relevance even in a single point tax system. In the VAT system, all prior taxes are given set off against output tax if the sale is not an exempt sale.

In VAT regime, the rates shall be uniform. However, it is possible that items under the exempted category and 4% category may be broadly similar across all States. Each State has its own VAT Act, Rules, Schedules, and Forms. Still there remain differences even in definitions among various Acts.

Petroleum products, like Aviation Turbine Fuel, Naphtha etc. used as fuel for running automobiles are brought under VAT, but credit cannot be taken on the tax paid thereon. Tobacco, Textiles and Sugar, which were under additional duty in lieu of excise and not under State taxation, are brought into the State Tax net at a rate not more than 4%, thereby integrating these products in the VAT structure.

Registration

Every dealer up to the retailer level is required to get registered with the Sales Tax department in order to

avail the credit of input tax. However, there is a threshold turnover level. The retailers with turnover below the threshold can opt not to register, but pay a nominal composition tax. However, such dealers are not entitled to take credit of prior stage tax, nor can they pass the credit to their buyers. In effect, the VAT chain breaks at that stage. Those opting not to register under VAT can opt for general registration.

Registration of dealers with gross annual turnover above Rs.5 lakh is compulsory. There is a provision for voluntary registration for dealers with gross annual turnover of less than Rs 5 lakh. All existing dealers get automatically registered under the VAT Act. A new dealer is allowed 30 days time from the date of his being liable to get registered.

Small dealers with gross annual turnover not exceeding Rs.5 lakh shall not be liable to pay VAT. States have flexibility to fix threshold limit within Rs.5 lakh. Small dealers with annual gross turnover not exceeding Rs.50 lakh who are otherwise liable to pay VAT, shall however have the option for a composition scheme with payment of tax at a small percentage of gross turnover. The dealers opting for this composition scheme shall not be entitled to input tax credit.

The entire design of VAT with input tax credit is crucially based on documentation of tax invoice, cash memo or bill. Every registered dealer, having turnover of sales above an amount specified, shall issue to the purchaser, who is entitled to tax credit and not to the final consumer, serially numbered tax invoice with the prescribed particulars. This tax invoice is to be signed and dated by the dealer or his regular employee, showing the required particulars.

Exempt Sale

When a certain sale is exempt from tax, the dealer effecting the exempt sale shall not be entitled to any VAT credit on the inputs purchased by him. The sales effected by him shall also be exempt from any tax. This results in breaking of the VAT chain.

Another example where reversal is made is when the goods are sold as samples or gifts i.e., non-taxable transactions and the input tax credit relating thereto have already been availed against output tax payable on other sale transactions. In such circumstances, the credit earned shall be reversed. This is called "Reverse Credit of Input Tax".

Stock or Consignment transfers are exempt from VAT as these were not under the purview of the State Tax Acts as well. The input tax paid on such commodities

or on the inputs that go into production of such commodities are available as credit to the extent of excess of input tax over and above 4%. Thus, if the inputs used in the commodity that is transferred, or the product itself when purchased, were taxed at 10%, credit can be taken by the transferring dealer to the extent of 6% against other taxable dispatches. Imported goods shall continue to be exempt from VAT on imports. Under VAT, there is no place for Entry taxes and Octroi.

Credit and Set-Off under VAT Regime

VAT aims at providing set-off for the tax paid earlier and this is given effect through the concept of input tax credit. Input tax credit in relation to any period means setting off the amount of input tax by a registered dealer against the amount of his output tax.

Tax paid on the earlier point is termed as, "input tax". This amount is adjusted against the tax payable by the purchasing dealer on its sales. This credit availability is called input tax credit. "Input tax" is the tax paid or payable in the course of business on purchase of any goods made from a registered dealer of the State. "Output tax" means the tax charged or chargeable under the Act, by a registered dealer for the sale of goods in the course of business. In other words, input tax is the tax a dealer pays on his local purchases including the goods that he purchases for resale, raw materials, capital goods as well as other inputs for use directly or indirectly in his business. Output tax is the tax that a dealer charges on its sales that are subject to tax. The input tax credit is available for both manufacturers and traders for purchase of inputs or supplies meant for sale within as well as outside the States, irrespective of these being utilized or sold. This results in reduction of tax liability.

Input tax paid in excess of 4% is eligible for tax credit in respect of stock or consignment or branch transfers of goods out of the State. Partial input tax credit is also available in respect of inputs used for manufacture of exempted goods.

Input tax credit is allowable to a registered dealer for purchase of any goods made within the State from a dealer holding a valid certificate of registration under the Act. Input tax credit on capital goods is available for traders and manufacturers.

Input tax paid under the VAT Act is eligible for being set off against Central Sales Tax payable on inter-State sales. Therefore, excess of input tax over and above the output tax payable under the VAT Act can be applied towards Central Sales Tax payable. While taxes paid on raw materials and inputs are eligible for set off against

taxes on output, taxes paid on capital goods are not eligible for immediate set-off. The reason perhaps is the huge credit that States may have to grant in cases of capital purchases of large value. Due to this, tax on capital goods may be granted, but over a certain period of time. However, the credit is limited only to capital goods actually used for manufacture and hence may not be available to a trader.

In some cases, the input tax paid and taken credit of may have to be reversed, for example, when the material is consumed for personal purposes and not business purposes, or when the input including packing materials is used for manufacture and/or sale as exempt goods etc.

All tax-paid goods purchased on or after April 1, 2004 and still in stock as on April 1, 2005 are eligible to receive input tax credit, subject to submission of requisite documents. In respect of resellers holding tax-paid goods on April 1, 2005, the input tax credit is given for the sales tax already paid in the previous year. This tax credit shall be available over a period of 6 months after an interval of 3 months needed for verification.

Assessment

The VAT liability is self-assessed by the dealer himself. It pre-supposes that all the dealers act in an honest manner. Scrutiny is done in cases where there are doubts arising due to under reporting of transactions or evasion of tax.

Audit

There shall no longer be compulsory assessment at the end of each year. Correctness of self-assessment is checked through a system of Department Audit. A certain percentage of the dealers are taken up for audit every year on a scientific basis. In case of detection of evasions during the course of audits, the concerned dealer may be taken up for audit for previous periods. This Audit Wing remain delinked from tax collection wing to remove any bias. The audit team conducts its work in a time bound manner and audit is completed within six months and the audit report is transparently sent to the dealer as well.

Simultaneously, a cross-checking through computerized system is done on the basis of coordination between the tax authorities of the State Governments and the authorities of Central Excise to compare constantly the tax returns and set-off documents of VAT system of the States and those of Central Excise. This comprehensive cross-checking

system helps in reduction of tax evasions and lead to significant growth of tax revenue.

Returns

The return filing procedures are designed in such a way that the compliance costs are minimum. A registered dealer is required to file a return along with the requisite details such as output tax liability, value of input tax credit, and payment of VAT.

Under VAT, there are simple forms of return, which are filed monthly, quarterly or annually as per the provisions of various State laws. Returns are accompanied with the challans evidencing payment of tax. In certain States, returns cum challan forms have been devised. In those cases, the returns along with the payment are required to be filed with the treasury.

Every return so furnished is required to be scrutinized expeditiously within the prescribed time limit from the date of filing the return. If any technical mistake is detected on scrutinizing, the dealer shall be required to rectify the defect or pay the deficit.

Zero Rating

Zero Rating means that the tax payable on sale of a commodity is fixed at 0%. Though apparently, it looks similar to an exempt transaction, there is a significant difference between the two. While in an exempt transaction, the tax paid on input lapses i.e., it cannot be set off, under the Zero rated sales. Prior stage tax is set off against the 0% tax paid and effectively the entire tax paid on purchases is eligible for refund. Thus, 'Zero Rating' is advantageous to the dealer compared to 'exempting' of sale transactions. Generally, export sales are zero-rated and thereby, exporters are granted refund of taxes paid by them on their inputs. Exporters gain significantly due to the 'Zero Rating'.

Refunds

Refunds are to be granted by the end of the financial year. Thus, the benefit of zero rating is not immediate, but deferred. Some States have also provided for refund where the tax paid on inputs exceeds the output tax payable and cannot be set off in a given period. In such cases, the excess tax not so set off shall be refunded after adjusting any dues towards interest, penalty etc, in accordance with the State VAT Act.

Goods and Service Tax

Conceptually although not presently so in India, VAT covers both tax on sale of goods and tax on services. In few countries such as, Singapore, Canada etc., it is known

as Goods and Service Tax. The Task Force headed by Dr. Vijay Kelkar had recommended a comprehensive goods and services tax.

Position of Company Secretaries in India

The profession of Practising Company Secretaries in India, which made a humble beginning in the sixties, has now reached greater heights. With the clear and blended knowledge of various laws that they possess have made firms of Practising Company Secretaries versatile professionals capable of rendering wide range of services in diversified fields through specialist partners who develop expertise in VAT.

Company Secretaries in Practice have now been recognized in India to act as an authorized representative for the purpose of appearing before VAT authorities under Statutes of various States as well, like; West Bengal Value Added Tax Rules, 2005 under Rule 2(1)(a)(iv) of the Rules; Bihar Value Added Tax Act, 2005, under Section 87(d) of the Act; Daman and Diu Value Added Tax Regulation, 2005, under regulation 82(1)(b) of the Regulation; and Goa Value Added Tax Act, 2005, under Section 82(1)(b) of the Act.

These States have begun the process of recognizing Practising Company Secretaries and others are bound to follow as VAT regime gets settled through out India.

In view of the Right to Information Act 2005 effective from October 12, 2005 recognising the right to information of the Citizens of India, company secretaries are now required to be more conscience keeper of the corporate affairs as their responsibilities have increased many folds in terms of filing of various important documents, records with Government bodies like, Commissioners, CBDT, CBEC, VAT authorities etc. Since the documents are of vital importance and depict insight of the company therefore, they are entrusted with greater responsibility so far as scrutinizing, filing and signing of the documents are concerned. This has placed company secretaries at an advantageous and responsible position adding further weightage to their roles in the changing scenario opening new vistas to the profession of Company Secretaries in India.

CONCLUSION

Initial tax revenue benefits can be reaped from extended geographic reach and from sharing capabilities in businesses that already have international elements. Longer-term revenue gains can arise from the transfer of capabilities in domestic as well as cross-border businesses. Once the institution has achieved substantial

size, the acquisition of large, competitively placed players in other countries becomes feasible.

Increasing liberalisation of the services sector has led to an urgent need for a review of indirect tax rules and VAT in particular. This is in order to ensure that such indirect tax rules are compatible with the need for correct and simple VAT taxation of such supplies. Most importantly, it should be clear to all market players what the consequences of VAT are, bearing in mind that indirect taxes are meant to be passed on to the consumer and should therefore in principle not create a burden for businesses.

Even, in certain EU countries as well, it has been felt that the unclear VAT treatment of certain transactions gives local tax authorities a certain freedom in their own interpretation often resulting in double taxation. Tax can no longer be taught or practised with a disregard for international tax and International tax can no longer be dealt with separately from domestic tax.

The major industrial powers, through the Organization for Economic Cooperation and Development (OECD), which is responsible for international tax treaties, have begun to focus on tax competition in the offshore tax havens.

At some point, this issue transforms from a tax competition to advanced economy protectionism with the rich nations seen as a tax cartel maintaining the poverty of poor nations. For instance, the U.S. can itself be seen as a tax haven with respect to its exclusion on taxing foreign investment income as well as its low income tax rates compared to many nations. It is critical to understand fully their own and their partner's policies in order to develop serving platforms with multi-country scope.

To facilitate cross-border planning for expatriates, the VAT planning team shall be quite different from the composition of the team required to engage in country-specific tax planning. Cross-border practices require a team of professionals to provide the necessary expertise.

Creating the appropriate team, involves forming strategic alliances with other professionals and using resources. Gaining access to cross-border planning expertise is an important issue. To perform well, the professionals need more specialization in VAT than just steady means. They must offer the potential services for, growth and improved profitability in existing businesses. Cross border entrepreneurs must look elsewhere for specialist partners to help in tax harmonization and expanding horizons. For example,

specialists not knowing what opportunities exist on the other side of the border, how the taxation system works or how their social security entitlements might be affected.

It is also true that the trails leading to cross-border taxation have been more thoroughly blazed in the path of future growth. Professionals need to pay a particular attention to the structure and flexibility of processing platforms to determine if any potential partners offer capabilities that would help them transform their tax policies.

Moving cross-border shall provide the specialists additional opportunities to reap the benefits of scale. Risk shall be diversified across markets and best practices be adhered to. The combination of large size and international scope of taxation can lower both overall costs and unit costs as activities shall move in most advantageous locations. If they move early, they will develop the experience and scale to be a regional and global tax consolidator. Once the professional specialists adopt cross border reach, they will tend to become a magnet for top talent and be well placed to capture the best tax governance opportunities. At the same time, they need to anticipate the changing tax strategies and consider what sort of services would allow them to build a competitively advantaged position to serve globally. While examining possible combinations, they need to have a clear vision of what new methodology could be followed.

The list of skills and technical knowledge required for cross-border consumption tax planning specialists is very vast, that is one of the reasons why we don't find many professionals specializing in this area. Cross-border specialists need to have a very strong technical and practical knowledge of a number of different areas (tax, legal, estate planning, immigration/emigration issues, etc.), on both sides of the border. In addition, a cross-border specialist needs to be able to integrate all of these areas into one cohesive plan.

New forces coming into play shall make cross-border consumption taxation more feasible and capable of creating value. As the international tax is removing old barriers, professionals are taking more global perspective, paying particular attention to VAT issues. The professionals that clear the cross-border hurdles will be able to gain and sustain competitive advantage in VAT regime. Obstacles there may be, but they are not insurmountable. To get started the professionals must concentrate and look at their current level of tax knowledge and determine how best they can improve further to serve globally.

In today's changing scenario, professionals that do not investigate cross-border VAT opportunities may end up alone as markets converge and national boundaries become less important. The danger of waiting too long to choose a specialist partner is that the attractive ones may quietly jump into the competition leaving others behind.

The cross-border practitioners need to be aware of compliance issues. If one is going to be working across borders there is a need to make sure that they are compliant with the different regulations to which their professional activities may subject them.

Since the key to growth as specialists under VAT regime is, to snatch opportunities internationally in order to have a competitive edge in dynamic cross-border environment. Therefore, it becomes imperative for us to ponder upon the following issues:

1. How do the specialists grow and become big in international scenario in the context of VAT regime ?
2. Will their position change within a span of few years if they stay the same size ?
3. Do they possess plans to make themselves attractive specialist partners ?
4. Do they need to be realistic about their domestic VAT scheme and about likely sources of growth. If the best opportunities clearly lie cross-border, do they have to compromise in order to integrate fully and achieve maximum benefits ?

5. Will the professionals be able to seize the cross-border opportunities, by assessing their current position and vulnerability ?
6. How would they feel if they achieve success in cross-border consumption taxation under VAT regime ?
7. Will the specialists be able to examine potential targets for cross-border taxation of equals in terms of possible synergies, value addition and development of future plans ?
8. Can the professionals quantify what additional skills and technical or non-technical competencies do they require while engaging in cross-border tax planning ?

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LIMITED LIABILITY PARTNERSHIP – A NEW BUSINESS MODEL

AUROBINDO SAXENA*

INTRODUCTION

The inclination to collaborate to accomplish certain commercial objectives has a long history. The commercial magnetism of such collaborations and a need to govern their business ultimately led to the codification of corporate and partnership laws.

GENESIS AND DEVELOPMENT OF PARTNERSHIP LAWS

Corporations and Partnerships have been a primary form of business structure for a long time now. For more than a century, partnership law has offered an all-embracing and lucid alternative to corporate law. Although, the two bodies of law have much in common, historically they differed sharply on the role of the contract and private ordering in structuring the firm.

Partnership law encourages private ordering through bargaining by providing an agreement amongst partners. In contrast, corporate law historically has provided a mandatory framework for firm structure highly resistant to shareholders' attempts to define their relationships through bargaining¹. Proponents of private ordering within firms prefer the freedoms of partnership law to the mandates of corporate law, and over time they have enjoyed success in extending the bargaining model from partnership law to corporate law.

However, certain inherent limitations of both these forms of business have made them unsuitable for certain businesses. This ultimately led to the evolution of certain hybrid forms of business structures such as limited partnerships, limited liability partnership, limited liability limited partnerships etc.

CONCEPT OF LLP

A limited liability partnership (LLP) is a hybrid corporate business vehicle that has a perpetual succession and separate legal entity. It not only provides the benefits of limited liability but also allows its partners the flexibility of organizing their internal structure as a general partnership.

The push for the creation of limited liability partnership grew from several factors, such as general increase in the incidence of litigation for professional's negligence and the size of claims; the risk to a partner's personal assets, when the claim exceeds the sum of the assets and insurance cover of the partnership; the growth in the size of partnerships; increase in specialization among partners and the coming together of different professions within a partnership.

However, the concerns centered on the fact that partners had unlimited personal liability irrespective of any fault or any degree of fault on the part of a particular partner and the partners generally. The level of protection that a limited liability partnership affords to its partners is an important factor that led to the proliferation of this form of business structure. Major professional and venture capital firms around the world prefer this model of business over the others.

The following paragraphs discuss the limited liability partnership laws around the world.

LLP LAWS IN UNITED STATES

The idea for the LLP has been credited to "a twenty-odd person law firm from Lubbock," Texas². Their idea, which led to the enactment of the first LLP statute in

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1 Robert W. Hillman, *The Bargain in the Firm: Partnership Law, Corporate Law, and Private Ordering Within Closely-Held Business Associations*.

2 Hamilton 1995 at 1073.

B A C K G R O U N D E R

Texas in 1991, was a reaction to the legal fallout from an economic calamity. The LLP was a direct outgrowth of the collapse of real estate and energy prices in the late 1980s, and the concomitant disaster that befell Texas's banks and savings and loan associations³.

The enactment of Texas legislation allowed members of certain professions who were carrying on business as ordinary partnerships to register as LLPs. Once a firm was registered as an LLP, each partner was shielded from personal liability claims against the firm arising from any future malpractice of other members of the firm.

The "Texas model" for LLP legislation has two key characteristics. Firstly, its liability shield only covers professional malpractice claims. Secondly, the liability shield does not protect a professional for personal malpractice, that is, where they are personally involved in the wrongful conduct or have direct supervisory responsibility over those who are personally involved in the wrongful conduct.

After Texas passed its LLP legislation, most other states quickly followed and today all 51 states have passed laws that permit the formation of an LLP⁴.

A limited liability partnership is considered as a special type of partnership that requires a special filing with the State where the partners operate. This partnership form offers all partners the right to participate in the management and the operation of a partnership without subjecting themselves to unlimited personal liability as is the case in general partnerships⁵.

However, if the special laws governing it are not precisely followed, they can be held as general

partnership in a court of law. Moreover, if the partners want, the old partnership agreement can continue to govern the newly formed LLP. A partnership, especially a limited liability partnership, transacting business in any state other than the state of domicile is required to register with the Secretary of the foreign state as a foreign partnership⁶.

LLP LAW IN JERSEY

The Channel Island of Jersey⁷ is a British Crown Dependency⁸. In 1997, Jersey enacted the Limited Liability Partnership (Jersey) Law 1997. The driving force that led to the codification of the legislation was that the major Accountancy firms in UK were facing a number of high profile lawsuits arising out of real/alleged audit failures. But even after their long campaign, they could not secure liability concessions from the UK government. As a result they approached the Jersey Authorities in mid 1990s to enact similar legislation⁹.

The Jersey LLP Bill was drafted by Ernst & Young and Price Waterhouse (now part of PricewaterhouseCoopers), at a private cost of more than £1 million¹⁰ and was designed to dilute 'joint and several' liability and reduce the redress available to audit stakeholders¹¹.

The Bill was "championed by the Island's leading politicians"¹² who also promised to 'fast track' it, effectively displacing the previously agreed legislative programme¹³ persuading some to conclude that Jersey was offering its 'legislature for hire'¹⁴ to enable major accountancy firms (or international capital) to hold other nation-states (e.g. the UK) to ransom. The approach to Jersey was accompanied by a threat that if the British government failed to match the liability concessions,

3 Hamilton 1995 at 1069.

4 See Alan R. Bromberg & Larry E. Ribstein, Bromberg & Ribstein On Limited Liability Partnerships, The Revised Uniform Partnership Act, And The Uniform Limited Partnership Act (2001) 15 (Aspen 2003) (hereinafter Bromberg & Ribstein "Limited Liability"). Some states, including New York, California, Nevada and Oregon, only offer LLP status to professional firms.

5 Margaret Bartschi, Foundations of Business Organizations for Paralegals, p. 3.

6 Angela Schneeman, The Laws of Corporations, and other Business Organizations, p. 42.

7 The Channel Islands consist of five island. These are Jersey, Guernsey, Sark, Herm and Alderney. Jersey is by the far the largest of these islands. Each island has its own government.

8 <http://www.cia.gov/cia/publications/factbook/geos/je.html>

9 Cousins et al, 1999.

10 The Accountant, November 1996, p. 5.

11 Globalization and its discontents: Accounting firms buy limited liability partnership legislation in Jersey by Prem Sikka, University of Essex.

12 Financial Times, 26 September 1996, p. 7.

13 Accountancy, September 1996, p. 29.

14 Hampton and Christensen, 1999a.

the firms would relocate their operations to Jersey¹⁵. The threat was sufficient to discipline the UK government and it promised similar legislation "within a week"¹⁶. The UK government eventually enacted the LLP legislation and the firms did not register in Jersey.

The externally drafted legislation was described by a member of Jersey parliament as "not offshore tax avoidance, on which our finance industry is built, but offshore liability avoidance"¹⁷.

As per the Jersey Law, an LLP is required to pay a £10,000 as registration fee, which makes it affordable only to businesses of stature.

The Act classifies partners as 'partners' and 'designated partners'. Every LLP must also have a registered office in Jersey at which it must maintain those records specified in Article 8(4) of the law, which are available for inspection by partners. The names and addresses of all the partners of an LLP are also a matter of public record. Similarly, LLPs are not required to file partnership agreement, accounts or to have their accounts audited; they must, however, maintain proper accounting records.

On a closer look at the provisions of the law, one finds that the provisions are somewhat similar to legislation in the State of Delaware (US). The law allows partners to take an active part in the management of a partnership whilst retaining their own individual limited liability. Every LLP is required to make a £5 million provision for judgments against the partnership and to compensate creditors. This financial provision against debts and liabilities of the partnership are required to be maintained throughout the life of the partnership and are not permitted to be made the subject of a security or set-off¹⁸.

Despite actually having a separate legal personality, the Jersey limited liability partnership is treated as a partnership for taxation purposes. It is rather fiscally transparent i.e. tax is levied on the individual partner's share of profits rather than the overall partnership profit. In this respect the Jersey LLP is also similar to the Scottish general partnership structure.

LLP LAW IN UNITED KINGDOM

In early 1997 the UK Department of Trade and Industry ("DTI") circulated a consultation paper that begins with the statement that the UK government had announced its intention to bring forward legislation at the earliest opportunity to make limited liability partnership available to regulated professions in the UK. As already discussed in preceding paragraphs this was a result of the pressure exerted by the major UK accountancy and law firms which were expected to take advantage of the Jersey LLP.

The UK Limited Liability Partnerships Act 2000 came into force on 6 April 2001¹⁹ providing limited liability partnership the organisational flexibility and tax status of a partnership with limited liability for its members.

The Act classifies partners into two categories namely 'members' and 'designated members'. A limited liability partnership must have at least two, formally appointed, designated members at all times. Designated members are similar to executive or managing directors and the company secretary of a company. If there are fewer than two designated members then every member automatically becomes a designated member. By virtue of section 24 of the UK Companies Act 1985, where a limited liability partnership continues for more than six months with a single member, then that member becomes liable jointly and severally with the LLP for the debts of the firms contracted for during that period.

The management structure of a limited liability partnership is governed by its agreement among members and LLP and members *inter se*. The agreement should cover the sort of issues dealt within a normal partnership agreement. It is however not mandatory to file the same with the Registrar. The First Schedule of the Act provides for certain default provisions which are applicable if the members agreement is silent on a certain issue.

A limited liability partnership is also considered to be a 'Legal Person' in its own right, and can operate in the same way as a company in most respects. However one important difference between an LLP and a limited company is the way in which the profits are taxed, with

15. Cousins et al., 1998.

16. Financial Times, 28 June 1996, p. 22; 24 July 1996, p. 9.

17. Jersey Evening Post, 25 July, 1996, p.1.

18. Jersey Evening Post, 25 July 1996, p. 1.

19. <http://www.volaw.com/pg405.htm>

each member of the partnership being taxed according to the share of the profits that they receive rather than the LLP paying tax directly on its profits.

A LLP is required to produce and publish financial accounts with a similar level of details to a similar sized limited company and to submit accounts and an annual return to the Registrar of Companies each year. This requirement is far more demanding than the position for normal partnerships and some specific accounting rules may lead to different profits from those of a normal partnership. Further, the Act applies the provisions of company law and insolvency law, with appropriate modifications, to LLPs.

LLP LAW IN SINGAPORE

In Singapore, a Study Team on Limited Partnerships (“LPs”) and Limited Liability Partnerships (“LLPs”) was set up by the Ministry of Finance in November 2002, to work out the details of the legal framework governing limited partnerships and limited liability partnerships. The Singapore Limited Liability Partnership Act, 2005 came into effect on April 11, 2005. By having a close look at the legislation, one can conclude that the Singapore LLP Act is broadly modelled on the Delaware Revised Uniform Partnership Act (the “Delaware Code”).

A LLP is required at all times to have at least two partners, with the exception that if the LLP is left with only one partner, the remaining sole partner is given a grace period of up to two years to find a new partner. If the LLP continues with less than two partners for more than two years, the remaining sole partner assumes unlimited liability and is vulnerable to winding-up by the courts.

It is mandatory for a LLP to have a local manager who is a natural person aged twenty one years and above and does not have a questionable character and must also meet other requirements specified under the LLP Regulations, including those pertaining to solvency. One of the important characteristics of a manager is that he need not be a partner of the LLP.

Although the LLP structure is available to all types of businesses yet it is not subject to full financial reporting and disclosure requirements, for example, relating to its capital contributions and changes to capital, making this a suitable vehicle for small businesses and new start-ups. Further, it is also not mandatory to file the partnership agreement with the Registrar.

LLPs are required to ensure that the partnership name is followed by the words ‘limited liability partnership’ or the acronym ‘LLP’. Invoices and official

correspondence are also required to carry the name, registration number and a statement that the partnership is registered with limited liability. Additionally, LLPs formed by conversion of existing unlimited partnerships are required to carry a statement regarding the conversion and the effective date on all official correspondence and invoices for 12 months commencing 14 days after the date of registration.

LLPs are also required to file a declaration of solvency or insolvency, which will be publicly available. Failure to file a declaration of solvency implies insolvency leaving the LLP vulnerable to winding-up action by creditors. As a measure of creditor protection, there is a claw-back mechanism, which allows LLPs to recover amounts distributed to its partners within a period of three years preceding the commencement of the winding up of an LLP.

INDIAN SCENARIO

In India, businesses mainly operate as companies, sole proprietorships and partnerships. Each of these business structures has its own advantages and shortcomings and is subject to different regulatory and tax regimes. The idea that there should be the opportunity in India to organize as an LLP emerged out of the Report of the Naresh Chandra Committee on Regulation of Private Companies and Partnership and Report of the Dr. J. J. Irani Expert Committee on Company Law. After studying the major LLP statutes around the World it is suggested that the Singapore LLP Act, 2005 along with the Indian Companies Act, 1956 with apposite adaptations and modifications may form a base to the Indian LLP statute.

ISSUES FOR CONSIDERATION

Some of the important issues that need indepth analysis, debate, discussion and deliberations are as under:

1. Whether LLP form of business structure should be made available to Professionals only ?
2. Whether LLP Agreement should be made mandatory to be filed with the Registrar ?
3. What contents of the LLP agreement should be filed with the Registrar ?
4. Whether foreign individuals should be allowed to be a partner or not ?
5. Whether LLPs should be allowed to have one general partner with unlimited liability or not ?
6. Whether manager should be a partner of LLP or not ?

7. Whether LLP should have a limit on the number of partners it can have ?
8. What should be the extent of liability of a partner ?
9. How should the LLPs be taxed ?
10. What should be the disclosure requirements for an LLP ?
11. What should be the procedure for existing firms, private companies and unlisted public companies to convert to LLP ?
12. How should the Act deal with foreign LLPs ?
13. What should be the procedure for the merger, amalgamation and demerger of LLPs ?
14. What should be the procedure for the winding up and dissolution of LLPs ?
15. What provisions of the Companies Act, 1956 should apply to LLPs ?
16. What all other legislations, rules, regulations and procedures need to be amended for facilitating a smooth entry of LLPs ?
17. What can be the various forms of contribution?
18. Whether a partner can bring his share of contribution in installments ?
19. For how long an LLP should be allowed to carry on business with less than two partners ?
20. Should the audit of financial records be made mandatory for all LLPs ?
21. Should LLPs be required to file an annual report with the Registrar ?
22. What should be the period of claw back ?
23. What should be the disqualifications of a partner and manager ?
24. Whether the provision for compulsory insurance for LLPs be provided ?
25. Who shall regulate and administer the LLPs ?

CONCLUSION

Following international trends, predominantly those in the United States of America, United Kingdom and Singapore, the debate on Limited Liability Partnership (LLP) structure in India is recent one. This structure is recognized as the "world's best practice" structure,

designed to not only attract venture capital from offshore institutional investors but also to retain domestic investment. Some of the advantages of this form of business structure include low cost of incorporation, unlimited capacity, limited individual liability, flexible management structure, tax benefits and less audit and filing requirements.

However, at the same time this form of business structure is susceptible to abuse as well. Probably the weakest link is the private limited liability partnership agreement. Especially, after the Enron collapse, it is felt that limited liability has a degree of correlation with professional lapses and malpractices. The OECD also identifies limited liability partnership as being a corporate vehicle, which is vulnerable to misuse, principally for the reason that it is less regulated than corporations.

The limited liability partnership form of business structure is keenly awaited in India. However, such introduction will require amendments in several legislations and Regulations. Therefore, an in-depth understanding of the concept is inexorable.

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CODES OF CORPORATE GOVERNANCE : AN ASIAN PERSPECTIVE

SHIKHA KATOCH*

GENESIS OF CORPORATE GOVERNANCE

Corporate Governance systems have evolved over several decades, often in response to corporate failures or systemic crises. The first well-documented failure of governance was the South Sea Bubble in the 17th century, which revolutionized business laws and practices in England. Similarly, much of the securities laws in US were put in place following the stock market crash of 1929. There has been no shortage of other crises either, such as the secondary banking crises of the 1970s in UK and savings and loan debacle of the 1980s in US. In addition to these major crises, history of corporate governance is also punctuated by a series of well-known corporate failures. Each crises or major corporate failure, often a result of incompetence, fraud and abuse, was met by an improved and more effective system of corporate governance.

Through this process of continuous change, developed countries have established a complex mosaic of laws, regulations, institutions in the Govt. and private sector. The purpose was not to shackle corporations but rather to balance the promotion of enterprise with greater accountability. The systematic enforcement of law and regulations has created a culture of compliance that has shaped business culture and the management ethos of firms, spurring them to improve as a means of attracting human and financial resources on the best possible terms. This continuous process of change and adaptation has accelerated with the increasing diversity and complexity of shareholders and stakeholders.

The developing world has also faced its own corporate governance challenges. The economic crisis in Asia, which started in July 1997 in Thailand and affected currencies and stock markets of several Asian Countries, demonstrated how macro economic difficulties can be intensified by a systemic failure of corporate governance stemming from weak legal and

regulatory systems, inconsistent accounting and auditing standards, ineffective oversight by corporate board of directors and little regard for the rights of minority shareholders.

CODES OF BEST PRACTICES FOR CORPORATE GOVERNANCE

Codes of Best Practices for Corporate Governance are important tools in corporate governance reform because they raise awareness and help build consensus and ownership of reform processes and outcomes. They are non-binding rules that go beyond the law, taking country-specific conditions into account and often exceeding the standards set by international guidelines. While adherence to such codes and standards is voluntary, compliance by specific companies sends a signal to investors to help them identify companies that match their criteria for investment. Since the release of the Cadbury Report, the importance of corporate governance standards and codes has become increasingly widespread. For example, countries such as Singapore have recently released its Code of corporate governance.

In the context of corporate governance, codes tend to be adapted to the country's economic environment and to address the countries' most serious governance problems. Despite differences between and among countries, codes tend to make similar recommendations regarding the behavior of the board, protecting the rights of shareholders by tackling, primarily, the transparency and accountability of board practices through encouraging an increase in the number of directors not part of the company's management and the creation of sub-committees of boards.

As stated above, successive corporate failures have been responsible for focused attention on corporate governance. This led to the evolution of Codes by the countries all over the world to suit their domestic

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requirements. Similarly, the international organisations such as World Bank, Organization for Economic Cooperation and Development, Commonwealth Association of Corporate Governance, Euro shareholders etc. have also lent support to the cause by bringing out their own principles, codes and guidelines on Corporate Governance.

CODES OF CORPORATE GOVERNANCE IN ASIA

In Asia, approximately two-thirds of listed companies, and substantially all private companies, are family-run. Over the last several decades, the collective talents and efforts of these family-business owners have resulted in strong economic growth and substantial increases in living standards. A particular characteristic of the Asian corporate landscape, however, is a tendency for such individuals (and their families) to establish large interlocking networks of subsidiaries and sister companies that include partially-owned, publicly-listed companies. On the one hand, the use of such subsidiaries and sister companies permits investors not only to place their money with the management team of their choice, but to direct this money to the markets and industries in which particular subsidiaries specialise and which investors believe hold the greatest potential for profits. On the other hand, such pyramidal structures can lead to severely inequitable treatment of shareholders. By conducting operations through a complex network of subsidiaries, controlling shareholders acquire control of operations and/or cash flows disproportionate to their equity stake in individual companies. The extent of this disproportionate control is frequently opaque to outsiders and undisclosed by insiders. A particular challenge for corporate-governance reform in Asia is, therefore, to encourage the dynamism and growth of family businesses while channelling their energies and operations into structures that are more transparent and, consequently, more clearly equitable for non-family investors.

The Asian business landscape comprises considerable legal and economic diversity. With respect to legal traditions, Hong Kong, China, India, Pakistan and Malaysia, for example, have common law frameworks. Thailand and the Philippines have frameworks based on French civil law, while China, Chinese Taipei and South Korea draw upon German civil law traditions. State ownership of enterprises remains strong, particularly in China and India, where aspects of stakeholder relations may draw upon or reflect elements of socialist law. Overlaying these legal traditions in many countries are behavioural norms arising from various cultural and religious traditions.

Since the 1997 financial crisis, Asian regimes have made considerable progress in raising awareness of the value of good corporate governance. To a large degree, raising awareness means convincing people that corporate governance is in their self-interest. Many Asian business leaders and controlling shareholders are thus being challenged to re-think their relationships with their companies and with the minority shareholders who lay claim to partial ownership in them. Such re-orientation in thinking requires not only a strong national commitment to corporate governance, but one that is also broad-based. Over the past several years, most Asian jurisdictions have substantially revamped their laws, regulations and other formal corporate-governance norms. The corporate landscape in most Asian countries is characterised by concentrated ownership. In many Asian jurisdictions, there have been instances where controlling shareholders of family dominated, publicly-listed companies and other enterprises with concentrated ownership have abused their control to exploit other shareholders. Regionally, exploitation of non-controlling shareholders has been identified as the most serious corporate-governance challenge.

The Asian Corporate Governance Association recently released the latest version of "CG Watch 2004", their annual survey of corporate governance in Asia. Titled "Spreading the word: Changing rules in Asia", the report covers corporate governance standards in 10 Asian markets and 450 large listed companies. In the survey, it has been found that despite the large amount of new rules in Asia in recent years in areas such as disclosure, board independence and accounting/auditing standards, there is still a long way to go before the region has a truly robust legal and regulatory regime for corporate governance.

In Asia, three-quarters of the region's major economies have a code of best practice or are developing one (Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Singapore and Thailand all have codes). Although this process started before the financial crisis in some common law jurisdictions in Asia, it was the recession that opened the floodgates to a fundamental rethinking as to how companies should be governed in future.

COMPARATIVE ANALYSIS OF ASIAN CODES OF CORPORATE GOVERNANCE

China

The main guardian of corporate governance in China is the China Securities Regulatory Commission. This is reflected in the Code of Corporate Governance that

was issued by the China Securities Regulatory Commission (CSRC) in 2002. This Code has more formal authority than similar codes in other countries due to the administrative pressure that the Commission may be able to impose on listed companies that fail to comply with them. However, this applies mainly to the mandatory provisions of the Code, with companies at least seeking to meet the minimum standards that the Code requires. The Code sets forth, among other things, the basic principles for corporate governance of listed companies in China, the means for the protection of investors' interests and rights, the basic behavior rules and moral standards for directors, supervisors, managers and other senior management members of listed companies.

The Code is applicable to all listed companies within the boundary of the People's Republic of China. Listed companies are required to act in the spirit of the Code in their efforts to improve corporate governance. The Code is the major measuring standard for evaluating whether a listed company has a good corporate governance structure, and if major problems exist with the corporate governance structure of a listed company, the securities supervision and regulation authorities can instruct the company to make corrections in accordance with the Code. The salient features of Code are:

- The corporate governance structure of a company shall ensure fair treatment toward all shareholders, especially minority shareholders. All shareholders are to enjoy equal rights and to bear the corresponding duties based on the shares they hold.
- Besides ensuring that shareholders' meetings proceed legally and effectively, a listed company shall make every effort, including fully utilizing modern information technology means, to increase the number of shareholders attending the shareholders' meetings.
- Written agreements shall be entered into for related party transactions among a listed company and its connected parties. Such agreements shall observe principles of equality, voluntariness and making compensation for equal value. The contents of such agreements shall be specific and concrete. Matters such as the signing, amendment, termination and execution of such agreements shall be disclosed by the listed company in accordance with relevant regulations.
- Institutional investors shall play a role in the appointment of company directors, the compensation and supervision of management and major decision-making processes.
- Listed company shall be separated from its controlling shareholders in such aspects as personnel, assets and financial affairs, shall be independent in institution and business, practice independent business accounting, and independently bear risks and obligations.
- A company shall establish a standardized and transparent procedure for director election in its articles of association, so as to ensure the openness, fairness, impartialness and independence of the election.
- A listed company shall introduce independent directors to its board of directors in accordance with relevant regulations. Independent directors shall be independent from the listed company that employs them and the company's major shareholders. An independent director may not hold any other position apart from independent director in the listed company.
- The board of directors of a listed company may establish a corporate strategy committee, an audit committee, a nomination committee, a remuneration and appraisal committee and other special committees in accordance with the resolutions of the shareholders' meetings. The audit committee, the nomination committee and the remuneration and appraisal committee shall be chaired by an independent director, and independent directors shall constitute the majority of committees.
- The supervisory board of a listed company shall be accountable to all shareholders. The supervisory board shall supervise the corporate finance, the legitimacy of directors, managers and other senior management personnel's performance of duties, and shall protect the company's and the shareholders' legal rights and interests.
- Supervisors shall have professional knowledge or work experience in such areas as law and accounting. The members and the structure of the supervisory board shall ensure its capability to independently and efficiently conduct its supervision of directors, managers and other senior management personnel and to supervise and examine the company's financial matters.
- A listed company shall establish fair and transparent standards and procedures for the

assessment of the performance of directors, supervisors and management personnel.

- The evaluation of the directors and management personnel shall be conducted by the board of directors or by the remuneration and appraisal committee of the board of directors. The evaluation of the performance of independent directors and supervisors shall be conducted through a combination of self-review and peer review.
- Information disclosure is the ongoing responsibility of listed companies. A Listed company shall truthfully, accurately, completely and timely disclose information as required by laws, regulations and the company's articles of association.
- When controlling shareholders increase or decrease their shareholding or pledge the company's shares or when the actual control of the company transfers, the company and its controlling shareholders shall timely and accurately disclose relevant information to all shareholders.

Hongkong

Hong Kong enjoys the distinction of being the first place in Asia to produce an official code of best practice before the Asian crisis. It released its Code in 1993, inspired in large part by the publication of the Cadbury Report in the UK in the year 1992. It remained the shortest code in Asia (at just over a page) and the most narrowly focused. Unlike more recent Asian codes, which all aim to cover the gamut of modern disclosure and accountability issues facing listed companies, the Hong Kong Code (1993) was limited to a few general statements about board meetings and the role of directors, with a brief reference to audit committees

Hong Kong's progress on the corporate governance front is well recognised by bodies such as the International Monetary Fund, which in its 2004 report, commended Hong Kong for its corporate governance improvements. On November 19, 2004, the Stock Exchange of Hong Kong published a final report on its new "Code on Corporate Governance Practices" (initially released in late January 2004 for public comment). The new Code is a big improvement on Hong Kong's original Code of Best Practice, a terse document dating back to 1993. It has been published in conjunction with a new set of rules requiring issuers to include a "corporate governance report" in their annual reports.

The Code on Corporate Governance Practices sets out the principles of good corporate governance, and two levels of recommendations: (a) code provisions; and (b) recommended best practices. Issuers must state whether they have complied with the Code Provisions set out in the Code for the relevant accounting period in their interim reports and annual reports. In the case of the Recommended Best Practices, issuers are encouraged, but are not required, to state whether they have complied with them and give considered reasons for any deviation. Issuers are expected to comply with, but may choose to deviate from the code provisions. The recommended best practices are for guidance only. Issuers may also devise their own code on corporate governance practices on such terms, as they may consider appropriate.

In each section, the Code sets out the Code Provisions and/or Recommended Best Practices, together with the underlying principles of the relevant provisions to assist listed issuers in developing their own code of board practices.

The Code has five sections dealing with directors, remuneration of directors and senior management, accountability and audit, delegation by the Board and communication with shareholders. The highlights of the Code are as follows:

- There are two key aspects of the management of every issuer – the management of the board and the day-to-day management of the issuer's business. There should be a clear division of these responsibilities at the board level to ensure a balance of power and authority, so that power is not concentrated in any one individual.
- The board should include a balanced composition of executive and non-executive directors (including independent non-executive directors) so that there is a strong independent element on the board, which can effectively exercise independent judgment. Non-executive directors, should be of sufficient caliber and number for their views to carry weight.
- An issuer should appoint independent non-executive directors representing at least one-third of the Board.
- There should be a formal, considered and transparent procedure for the appointment of new directors to the board. There should be plans in place for orderly succession for appointments to the board. All directors should

be subject to re-election at regular intervals. An issuer must explain the reasons for the resignation or removal of any director.

- Every newly appointed director of an issuer should receive a comprehensive, formal and tailored induction on the first occasion of his appointment, and subsequently such briefing and professional development as is necessary, to ensure that he has a proper understanding of the operations and business of the issuer and that he is fully aware of his responsibilities under statute and common law, the Exchange Listing Rules, applicable legal requirements and other regulatory requirements and the business and governance policies of the issuer.
- All directors should participate in a programme of continuous professional development to develop and refresh their knowledge and skills to help ensure that their contribution to the board remains informed and relevant. The issuer should be responsible for arranging and funding a suitable development programme.
- The board of directors of a listed company should establish an audit committee, a nomination committee, and a remuneration committee. Board Committees should be formed with specific written terms of reference, which deal clearly with the committees' authority and duties.

India

In India Confederation of Indian Industry (CII) took a special initiative on Corporate Governance – the first institutional initiative in Indian industry. The objective was to develop and promote a code for Corporate Governance to be adopted and followed by Indian companies, be these in the Private Sector, the Public Sector, Banks or Financial Institutions, all of which are corporate entities. The final draft of this code was widely circulated in 1997. In April 1998, the code was released. It was called Desirable Corporate Governance: A Code. The salient features of the Code are as under:

- The Board should have a core group of excellent, professionally acclaimed non-executive directors who understand their dual role of appreciating the issues put forward by management, and of honestly discharging their fiduciary responsibilities towards the company's shareholders as well as creditors.
- For non-executive directors to play an important

role in corporate decision-making and maximizing long-term shareholder value, they need to become active parts and not relegate decisions in board into passive advisors; have clearly defined responsibilities within the Board such as Audit Committee; and

- Know how to read a balance sheet, profit and loss account, cash flow statements and financial ratios and have some knowledge of company laws. This, of course, excludes those who are invited to join boards as experts in other fields such as science and technology.
- It would be desirable for Financial Institutions as pure creditors to re-write their covenants to eliminate having nominee directors except in the event of serious and systematic debt default an in case of the debtor company not providing six monthly or quarterly operational data to the FIs concerned.

Following CII's initiative, the Securities and Exchange Board of India (SEBI) set up a committee under the chairmanship of Kumar Mangalam Birla to promote and raise the standards of corporate governance. The Birla Committee Report was approved by SEBI in December 2000. The said report led to introduction of Clause 49 in the listing agreement requiring companies to comply with the corporate governance norms.

Following CII and SEBI, the Department of Company Affairs (DCA) modified the Companies Act, 1956 to incorporate specific corporate governance provisions regarding independent directors and audit committees. Then came the Companies (Amendment) Act, 2000 which introduced many provisions relating to Corporate Governance like additional grounds of disqualification of directors in certain cases, setting up of audit committees, Directors' Responsibility Statement in the Directors' Report etc.

The Enron debacle of 2001 involving the hand-in-glove relationship between the auditor and the corporate client, the scams involving the fall of the corporate giants in the U.S. like the WorldCom, Qwest, Global Crossing, Xerox and the consequent enactment of the stringent Sarbanes Oxley Act in the U.S. were some important factors which led the Indian Govt. to wake up and in the year 2002 Naresh Chandra Committee was appointed to examine and recommend inter alia drastic amendments to the law involving the auditor-client relationships and the role of independent directors. In 2002 SEBI analyzed the statistics of compliance with the Clause 49 by listed companies and felt that there

was a need to look beyond the mere systems and procedures if Corporate Governance was to be made effective in protecting the interest of the investors. SEBI therefore constituted a committee under the Chairmanship of N.R.Naranyana Murthy, Chairman and Mentor of Infosys Technologies Ltd. and mandated the said committee to interalia review the performance of Corporate Governance in India and make appropriate recommendations. The Committee submitted its report in the year 2003. On the basis of recommendations of the Committee SEBI revised the Clause 49 of Listing Agreement. However SEBI received representations/suggestions from the corporate/public on various provisions in the revised clause. The Narayan Murthy Committee then considered and deliberated on the suggestions and comments received from corporate/public. Based on the revised recommendations of the Committee, it was decided to further revise the provisions of Clause 49 of the Listing Agreement. The revised clause will be effective from January 1, 2006.

Recently the Ministry of Company Affairs has set up National Foundation for Corporate Governance (NFCG) in partnership with CII, ICAI and ICSI. The NFCG would focus on the following areas:

- Creating awareness on the importance of implementing good corporate governance practices both at the level of individual corporations and for the economy as a whole. The foundation would provide a platform for quality discussions and debates amongst academicians, policy makers, professionals and corporate leaders through workshops, conferences, meetings and seminars.
- Encouraging research capability in the area of corporate governance in the country and providing key inputs for developing laws and regulations, which meet the twin objectives of maximizing wealth creation and fair distribution of this wealth.
- Working with the regulatory authorities at multiple levels to improve implementation and enforcement of various laws related to corporate governance.
- In close coordination with the private sector, work to instill a commitment to corporate governance reforms and facilitate the development of a corporate governance culture.
- Cultivating international linkages and maintaining the evolution towards convergence

with international standards and practices for accounting, audit and non-financial disclosure.

- Setting up of 'National Centres for Corporate Governance' across the country, which would provide quality training to Directors as well as produce quality research and aim to receive global recognition.

Indonesia

Since 2000, Indonesia has taken important steps to address the weaknesses that contributed to the economic crisis of 1997. As a result, the corporate governance framework has been strengthened. The equity markets grew significantly in 2003. The equity markets relative to other East Asian countries, however, remain small, with a market capitalization of approximately 26 percent of the GDP in 2003. The ownership structure of companies in Indonesia is characterized by concentrated ownership, family-owned businesses, and controlling shareholders. The business culture is known to be relationship-based rather than rule-based. Most listed companies are either controlled by families or, in the case of state-owned enterprises, by the government.

The companies incorporated under the Indonesian Company Law has two boards (thus called the two-board system) the Board of Commissioners (Komisaris) that performs the supervisory and advisory roles, and the Board of Directors (including management) that performs the executive role. Thus, someone who is called a "director" in an Indonesian setting is actually part of the executive team, whereas in other jurisdictions they might be part of the supervisory/advisory team or part of the executive team.

In 1999, the National Committee on Corporate Governance was established through a ministerial decree. It is responsible for strengthening, disseminating, and promoting good corporate governance principles in the private sector. Since its establishment, it has developed a Code of Good Corporate Governance in the year 2001, which is an improvement from the previous version of the Code, which was developed in the year 2000.

The salient features of the Code are as follows:

- The rights of the shareholders shall be protected and, accordingly, shareholders shall be able to exercise their rights through reliance upon appropriate procedures that have been adopted by the Company concerned, which procedures

shall be required under applicable regulations having the force of law.

- Shareholders owning a controlling interest in a company shall be mindful of their responsibilities as shareholders when they exercise any influence over corporate management, whether by the exercise of their voting rights or otherwise. Any unlawful intervention in the management of the company should be addressed through greater transparency, accountability of management and ultimately resolved by prevailing law. Minority shareholders also have corresponding responsibilities to the effect that they do not misuse their rights under the prevailing regulations having the force of law.
- Shareholders of the same kind of shares shall be treated equitably based on the principle that shareholders of the same kind of shares have equitable position in the company.
- The Dewan Komisaris (Commissioners) shall be responsible and shall have the authority to supervise the actions of Direksi (Board of Managing Directors) and shall give advise to the Direkshi when required. To assist it in doing so, the Dewan Komisaris may, pursuant to the procedures it has adopted, retain independent professional advisors and/or establish special committees. Each member of the Dewan Komisaris shall be a person of good character and shall have relevant experience.
- The Dewan Komisaris shall establish a transparent system for (a) the appointment of the executives who are not members of the Direksi; (b) the determination of their remuneration; and (c) the evaluation of their performance.
- The Dewan Komisaris shall consider to establish from among their members certain committees to support the implementation of the tasks of the Dewan Komisaris. Those Committees are Nomination Committee, Remuneration Committee, Insurance Committee, and Audit Committee.
- The Direksi are charged with the overall management of the company. The Direksi shall be responsible for the implementation of their duties to the shareholders at the General Meeting of Shareholders.
- The Direksi (Board of Managing Directors) should be composed in such a way that its

members act independently by means that they shall hold no interests that might impair their ability to perform their duties independently and critically. Depending on the specific character of the Company, at least 20% of the members of the Direksi should be “outside directors” in order to increase the effectiveness of its management role, and the transparency of its deliberations. Such members of the Direksi shall be independent from the Dewan Komisaris (Board of Commissioners) and controlling shareholders.

- Stakeholders shall be provided with an opportunity to monitor and offer input to the Company’s Direksi. Whereas, the Company shall provide stakeholders with relevant information necessary for protecting their rights. The Company will cooperate with stakeholders for their mutual benefit.
- In addition to the contents of the annual report required by prevailing regulations having the force of law, companies shall take initiative to disclose not only matters required under the regulations having the force of law, but also those of material importance to the decision-making of institutional investors, shareholders, creditors and other stakeholders with respect to such matters such as but not limited to the company’s objectives, business goals and strategies, status of major shareholders and all other shareholders and pertinent information on the exercise of shareholders’ rights.

Korea

Having been battered by the Asian crisis and with heavily indebted local conglomerates, Korea has moved forward aggressively on corporate governance reform. In early 1998, the Korea Stock Exchange ruled that listed companies must allocate 25 per cent of their board seats to independents (a proportion that has since been raised to 50 per cent from 2001 for the biggest companies). And in September 1999, Korea published its “Code of Best Practice for Corporate Governance”. One of the most comprehensive and ambitious of its kind in Asia, the code states in its preamble: “Corporations are the entities that create new economic value. And the competitiveness of businesses is crucial in determining the competitiveness of a country. Korean corporations must also take progressive and proactive measures towards meeting the global trend to survive international competition. A faultless corporate governance system -

this is a major factor in making investment decisions the globalised capital market.”

The contents of the Code consist of five sections and recommendations viz. Preamble, Shareholders, Board of Directors, Audit Systems, Stakeholders, and Management Monitoring by the Market. For each section, the code is presented, along with appended notes to aid understanding. The salient features of the Code are as follows:

- Shareholder rights shall be protected, and shareholders shall be able to exercise their rights through proper procedure. Shareholders shall be treated equitably under the principle of shareholder equality. Controlling shareholders have the corresponding responsibilities when they exercise any influence toward the corporate management other than the exercise of voting rights.
- Shareholders, as owners of the corporation, possess basic rights including inter alia a right to participate in profit sharing; a right both to attend and to vote at general shareholder meetings; a right to obtain relevant corporate information in a timely and regular manner.
- Shareholders shall hold fair voting rights according to the type and number of shares possessed, and all shareholders shall equally be in possession of corporate information.
- The Board shall be composed so as to allow effective decision-making and supervision of the management. The number of directors shall be such that it allows the Board to have fruitful discussions and to make appropriate, swift and prudent decisions. For large public corporations, it is highly advised that the number of directors on the Board be appropriate for effectively managing internal committees.
- The Board shall include outside directors capable of performing their duties independently from the management, controlling shareholders and the corporation. The number of outside directors shall be such that the Board is able to maintain practical independence. Particularly, it is recommended that financial institutions and large-scale public corporations gradually increase the ratio of outside directors to over half of the total number of directors (minimum three outside directors).
- Outside directors shall hold no interests that may hinder their independence from the

corporation, management or controlling shareholder. The outside director shall submit a letter of confirmation, which the corporation shall disclose, stating that he holds no interests affiliated with the corporation, management or controlling shareholder at the time of his consent to the appointment.

- To have the Board run efficiently, committees composed of some of the directors may be established within the Board. The Board may, if necessary, establish internal committees that perform specific functions and roles, such as the Audit, Operation and Remuneration Committees.
- Rights of stakeholders according to the law and contract shall be protected, and stakeholders shall hold appropriate means of redress for infringement of rights. Corporations shall observe creditor protection procedures concerning matters, such as mergers, capital decrease and split mergers, which greatly affect the position of creditors. The corporations shall notify beforehand the creditors concerned for matters that may bring changes in the creditors' priority, or may have material influence on the possibility of collecting credit.
- Corporations shall not be negligent in their social responsibilities such as consumer protection and environmental protection.
- Corporations shall disclose material information in a timely and accurate manner. Corporations shall disclose any information, not just limited to those required under law that may materially influence the decision-making of shareholders and other stakeholders.

Malaysia

In Malaysia, historically, while developmental initiatives to improve the various aspects of the legal and institutional framework for corporate governance have progressed on a periodic and ongoing basis, the financial crisis provided the further impetus necessary for the adoption of a concerted and holistic approach towards corporate governance reform by both Government and industry.

In March 1998, a high level Finance Committee on Corporate Governance, comprised of both government and industry was formed for the purpose of swiftly identifying and dealing with weaknesses highlighted by the crisis in the then existing governance framework.

The Finance Committee's findings, which were reported through the publication of the Finance Committee Report on Corporate Governance in March 1999, represents the end-product of an extensive collaborative effort between government and industry, with the implementation of key aspects of the Report, such as the introduction of the Malaysian Code on Corporate Governance, having been spearheaded by industry.

The Malaysian Code on Corporate Governance, released in March 2000, provides a set of principles and best practices for companies on corporate governance. The Code is the product of an industry-led working group, established under the auspices of the Finance Committee on Corporate Governance. The Code sets out four forms of recommendations. Part 1 sets out broad principles of good corporate governance for Malaysia. Part 2 sets out best practices for companies. Part 3 is not addressed to listed companies but to investors and auditors to enhance their role in corporate governance. These are purely voluntary. Part 4 provides explanatory notes to the principles and best practices set out in Parts 1 and 2 and exhortations set out in Part 3. Additionally Part 4 also sets out best practices directed at listed companies that do not require companies to explain circumstances justifying departure from best practices - "mere best practices". The salient features of the Code are as follows:

- The board should include a balance of executive directors and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision making.
- There should be a formal and transparent procedure for the appointment of new directors to the board.
- The board should explicitly assume the six specific responsibilities, which facilitate the discharge of the board's stewardship responsibilities viz. Reviewing and adopting a strategic plan for the company; Overseeing the conduct of the company's business to evaluate whether the business is being properly managed; Identifying principal risks and ensure the implementation of appropriate systems to manage these risks; Succession planning, including appointing, training, fixing the compensation of and where appropriate, replacing senior management; Developing and implementing an investor relations programme or shareholder communications policy for the company; and Reviewing the adequacy and the integrity of the company's internal control systems and management information systems, including systems for compliance with applicable laws, regulations, rules, directives and guidelines.
- There should be a clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the roles are combined there should be a strong independent element on the Board. A decision to combine the roles of Chairman and Chief Executive should be publicly explained.
- Non-executive directors should be persons of calibre, credibility and have the necessary skill and experience to bring an independent judgement to bear on the issues of strategy, performance and resources including key appointments and standards of conduct. To be effective, independent non-executive directors need to make up at least one third of the membership of the board.
- As an integral element of the process of appointing new directors, each company should provide an orientation and education program for new recruits to the Board.
- The board of every company should appoint a committee of directors viz. audit committee, nomination committee, remuneration committee. Where the board appoints a committee, it should spell out the authority of the committee, and in particular, whether the committee has the authority to act on behalf of the board or simply has the authority to examine a particular issue and report back to the board with a recommendation.
- The Committee of directors should be composed exclusively of non-executive directors, a majority of whom are independent with the responsibility for proposing new nominees for the Board and for assessing directors on an on-going basis.
- Boards must maintain an effective communications policy that enables both the board and management to communicate effectively with its shareholders, stakeholders and the public generally. This policy must effectively interpret the operations of the company to the shareholders and must accommodate feedback from shareholders,

which should be factored into the company's business decisions.

Singapore

Singapore authorities have placed an increasing emphasis on corporate governance, generally benchmarking local standards to international best practices. In December 1999, the Government established three private sector-led committees to review and enhance the existing framework for corporate law and governance- the Corporate Governance Committee (CGC), the Disclosure and Accounting Standards Committee (DASC), and the Company Legislation and Regulatory Framework Committee (CLRFC).

The Code of Corporate Governance (the "Code") was first issued by the Corporate Governance Committee on 21 March 2001. Compliance with the Code was not mandatory but listed companies were required under the Singapore Exchange Listing Rules to disclose their corporate governance practices and give explanations for deviations from the Code in their annual reports for Annual General Meetings ("AGMs") held from 1 January 2003 onwards.

The Code sets out recommended corporate governance principles and practices in areas such as board composition, board performance, directors' remuneration, accountability, and communication with shareholders. The private sector-led Council on Corporate Disclosure and Governance (CCDG) is responsible for regularly updating the Code to ensure it remains relevant and consistent with international practices.

The Council on Corporate Disclosure and Governance initiated a review of the Code in May 2004 and submitted its recommendations to the Ministry of Finance in June 2005. The Ministry of Finance issued a revised Code on 14 July 2005, after considering the CCDG's recommendations.

The Code of Corporate Governance 2005 issued by the Ministry of Finance supersedes and replaces the Code that was issued in March 2001. The Code of Corporate Governance 2005 takes effect from AGMs held on or after 1 January 2007. Listed companies should disclose their corporate governance practices and explain deviations from the Code of Corporate Governance 2005 in their annual reports for AGMs held from 1 January 2007 onwards.

The salient features of the Codes are as follows:

- There should be a strong and independent element on the Board, which is able to exercise

objective judgement on corporate affairs independently, in particular, from Management. No individual or small group of individuals should be allowed to dominate the Board's decision making.

- There should be a clear division of responsibilities at the top of the company – the working of the Board and the executive responsibility of the company's business – which will ensure a balance of power and authority, such that no one individual represents a considerable concentration of power.
- Every director should receive appropriate training (including his or her duties as a director and how to discharge those duties) when he is first appointed to the Board. This should include an orientation program to ensure that incoming directors are familiar with the company's business and governance practices. It is equally important that directors should receive further relevant training, particularly on relevant new laws, regulations and changing commercial risks, from time to time.
- There should be a formal and transparent process for the appointment of new directors to the Board.
- Non-executive directors should constructively challenge and help develop proposals on strategy; and review the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.
- There should be a formal assessment of the effectiveness of the Board as a whole and the contribution by each director to the effectiveness of the Board.
- The Board should set up an Audit Committee, Remuneration Committee.
- Companies should engage in regular, effective and fair communication with shareholders.
- Companies should regularly convey pertinent information, gather views or inputs, and address shareholders' concerns. In disclosing information, companies should be as descriptive, detailed and forthcoming as possible and avoid boilerplate disclosures.

CODE CONVERGENCE IN ASIA

There is a diversity of corporate governance systems in the Asian countries. Despite the diversity of corporate governance systems, the globalization of markets is producing a degree of convergence in actual operations and governance practices. Countries compete on the price and quality of their goods and services. They compete for financial resources in global capital markets. Increasingly they also compete on their regimes for corporate governance. These global market pressures are providing the impetus for harmonization of corporate governance practices.

Over the last few years different country groups have been establishing their own common set of benchmarks for corporate governance, for instance, the OECD Council called upon the OECD to develop a set of corporate governance standards and guidelines and published in May 1999 a common set of guiding principles of corporate governance for all OECD member countries. These Principles are intended to assist OECD and non-OECD Govt. in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries and to provide guidance and suggestions for stock exchanges, investors, corporations and other parties that have a role in the process of developing good corporate governance. The OECD revised its Principles in the year 2004 to respond to the corporate governance developments including corporate scandals that further focused the minds of Governments on improving corporate governance practices.

It is widely believed that "one size does not fit all", meaning North America and Europe should not seek to impose their standards on developing economies and that an international code of best practice is unworkable. Legal systems, business cultures and corporate structures are just too different, even among developed nations. The OECD also reflects this view in the preamble to its "Principles of Corporate Governance", where it states: "There is no single model of good corporate governance."

An analysis of the Codes of Corporate Governance in Asian countries indicates that Asian countries are moving towards identical systems of governance. There is a striking agreement on the centrality of certain principles. These include:

- enhancing shareholder value as the primary focus of companies, and upholding or extending shareholder rights;

- the need for non-executive and independent non-executive directors to provide an "outside" view on strategic direction and to counterbalance the executives on the board;
- the usefulness of board committees responsible for audit, nomination and compensation and comprising a majority of independent directors; and
- the importance of higher levels of information disclosure from listed companies.

The aforesaid principles have been included in codes of best practice developed in the Asian countries over the past years. One of the most interesting cases of governance development in Asia concerns audit committees. Singapore mandated them as early as 1989- following the collapse of a major conglomerate and a market crisis in the mid-1980s - and stated that they must comprise a majority of independent directors. Malaysia followed suit in 1994. Thailand announced in early 1998 that all listed companies must form them by December 1999. Korea also made them mandatory for the listed subsidiaries of the top 30 conglomerates in 1999. In Hong Kong, however, audit committees are merely part of a code of best practice appended to the listing rules and are not compulsory (although since January 1999 it has been mandatory for companies to disclose whether or not they have such committees). Audit committees are also mandatory in India, where they have been included in recent years by inclusion of Clause 49 in the listing agreement requiring companies to follow corporate governance norms.

This example shows that while there may have been variation in implementation, there has been convergence in policy direction; and that this convergence has grown over time. A similar theme runs through the other areas where convergence is occurring.

POINTS OF DIVERGENCE

Convergence does not imply total uniformity, some key differences remain. One difference involves the "stakeholder" concept. Four countries explicitly subscribe to this principle as part of their corporate governance regimes viz. China, Korea, Japan and Thailand. Two others, Singapore and Malaysia, recognize the social importance of corporations, but do not emphasize stakeholders within the governance context. Singapore uses other means, such as legislation, to protect employees, creditors and customers. Malaysia encourages boards to be "responsible for relations with stakeholders", but stresses that they are "accountable to the shareholders".

A second difference concerns board structure: whether there should be single-tier or two-tier boards. Most countries have the former. Interestingly, Korea, despite the historic influence of Japan, does not have two-tier boards. While Thailand is alone in considering moving from single-tier to two-tier (it sees this as a way to enhance board independence).

The other major differences reflect different regulatory or legal systems. Singapore, Malaysia, Hong Kong, China have Anglo-Saxon legal systems whereas other economies have a variety of roots in their legal systems.

CONCLUSION

As the Asian crisis has shown, attitudes towards corporate governance among market regulators, government officials and professional associations can change quickly. What doesn't change so fast is business practice - except where it needs. Convergence also has its limits: Asian governance will never simply become a carbon-copy of the Anglo-American model, since local business cultures and legal systems will shape the way in which these ideas are adapted by each country. At the very least, family ownership in most countries and state ownership in places like China will continue to exert a powerful influence over the pace of change, the details of new regulations and the degree of power allowed minority shareholders. Nor will Asian countries move towards a single "Asian" model of governance, given the diversity that exists in current governance systems, the variations in regulatory philosophy, and differing political systems.

This status quo has to compete with other ideas and processes, many of which will become more influential over time. The internationalisation of finance is driving a demand for common standards. Asian companies operating internationally will increasingly see greater financial and non-financial disclosure, and accountability to all shareholders, as in their commercial interests.

Governments will continue to push corporate governance as fundamental to the development of advanced and attractive securities markets. Groups of shareholders will exercise their new-found and newly learned rights (through the Internet and other means). The convergence at the policy level in Asia towards the Anglo-American shareholder model cannot but have a profound impact on Asian business.

As corporate governance is the product of a complex set of cultural, economic and social issues and that the

governance structures of corporations differ from country to country, it is appropriate that corporate governance guidelines and practice code be designed and adopted by each constituent country. In the end, corporate governance should produce an environment within each country that corporations identify with and can adhere to in their decision-making processes.

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GLOBAL CORPORATE GOVERNANCE AND FAMILY OWNED ENTITIES

RITU VIJ KOHLI*

A recent study by CRISIL (a credit rating company) has revealed some very interesting facets to the debate on whether Indian companies fit the bill when it comes to Corporate Governance. The study takes the top 50 Indian companies—chosen from the NSE's, S&P, CNX, Nifty 50 index and compares them on some key parameters with the top 50 companies in the US which were chosen from the NYSE 100 index. The study finds that:

- 48% of Indian companies have the largest shareholder, holding over 50% stake. However, in the US, among the top 50, the largest shareholder holds less than 10%
- In India, the largest Board size is 17 and the smallest is 4, with 44% of the 50 companies having more than 12 directors. In the US, the largest board size is 18, the smallest 10, and 66% of the 50 companies have over 12 directors
- Out of the 50 Indian companies, 58% have majority independent boards, while 12% have less than one-third independent directors. On the other hand, in the US, all the 50 companies have majority independent boards.
- In India, 35 of the 50 companies have 50% or more executive directors—those performing key functions in the company—on the boards, while in the US, 98% of the companies have less than 25% executive directors, which means the majority directors on the US boards are non-executive directors.
- 60% of the 50 Indian companies have separate chairmen and CEOs, while this figure is only 20% for the US companies. A lead independent director—a kind of representative for independent directors on the boards—is present in only three of the 50 Indian companies. In the US, all the 50 companies

have fully independent audit, remuneration and nomination committees. In India, percentages of companies having independent committees vary.

What do these findings really mean for Corporate Governance in India? From the facts given above, it can be argued that the majority of Indian companies are closely held or may be classified as Family Controlled companies. Therefore there is need to address the Corporate Governance issues related to Family Control in the Companies in India.

Corporate Governance is defined as the structures, systems and the processes that provide direction, control and accountability for an enterprise. In a macro perspective, task of having good Corporate Governance in India entails creating institutions and systems which lead to better transparency and good governance. It however cannot be achieved unless there is clear understanding of the underlying control structures of the Indian companies.

For example, as in many Indian companies, a major shareholder, who is also chairman of the company, is able to give a more long-term direction than, say, a professional chairman in a widely-held company, like in the US.

DEFINING A FAMILY FIRM

Before we proceed further it is very important to define a Family Firm. This is necessitated because, some authors refer to any firm with a dominant shareholder as a family firm. By this definition, Microsoft is a family firm, even though Bill Gates has given no notice of any clear intention to pass control on to his children. Likewise, this definition would catch Andrew Carnegie's turn of the century Carnegie Steel as a family firm, even though he ultimately sold out and gave the \$480 million he received away to charities.

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In this article, we would define family firm more narrowly to encompass only companies run by heirs of the people previously in charge or by families that are clearly in the process of transferring control of the companies to heirs.

Approximately one third of the 1000 largest companies in the world are controlled by families. Of these, half are traded publicly and half are privately held. The vast majority require a different model of governance than is the norm for widely held companies.

FAMILY BUSINESSES : PROS AND CONS

With ownership controlled by one or a few people from a family, family firms have competitive advantages and disadvantages over publicly held companies. On the plus side, controlling ownership can take the long-term view. Patient, consistent investments can yield excellent future benefits. Investments in corporate culture can yield higher benefits than companies that are run for short-term. When looking at the returns of family owned companies versus the overall market, their stocks significantly outperform, in part because their leadership tends to be more stable than most and the companies largely embrace a long term approach to growth. On the other hand, firms controlled by a few can be isolated and insulated from market realities. Seeking personal comfort and forsaking external accountability can lead to stale strategy, no succession planning, and organizational stagnation.

Another advantage of family control is that families, because of the blood ties that unite them, are better able to manage corporate affairs smoothly. However the actual governance of family firms is replete with interfamilial disagreements, especially disputes about succession, the exploitation of some family members by others, and so on. We have recently seen ad-hoc price movements in Reliance Stock when the two Ambani brothers were fighting over control of the Reliance group. And unchecked quarrels among family owners can be catastrophic to a company.

The difference between a family owned business that succumbs to its weaknesses and one that exploits its relative strengths lies in the quality of the governance system. Successful family companies appreciate the power of their ownership control, volunteer for the accountability of an independent board, and take to properly defined roles and responsibilities of ownership, management, and the board of directors.

Successful family firms also understand how governance practices need to evolve to reflect the changes in the business and within the family.

Family Business and Agency Problem

It is a belief that family businesses are allegedly free of agency problems. Agency problems occur when the professional managers in a public company maximize their personal utility, rather than the wealth of the investors. For example, a professional manager might spend crores of rupees on an unnecessary executive jet that gives him utility, even though this decreases the value of the company. However, it is a myth to believe that professional managers squander away more wealth than a family member of the controlling family. The reason being shareholders limit the squandering by professional managers

In Public Companies, shareholders limits the agency problems of this sort. Large shareholders are unlikely to allow professional managers too much leeway to neglect the firm. Shareholders play a very crucial role to achieve good Corporate Governance in the Companies.

How Governance Differs in Family Businesses

Family business governance systems are more suited to the pursuit of unconventional strategies. Family businesses can more readily bypass the adversarial qualities of conventional business governance. Ownership can exert influence and care on multiple levels, making the family an agent of more effective decision making in management, on the Board, and among owners. Rather than functioning as a costly system of checks and balances, governance in family business often serves to enable transparency and partnership across the system. This, in turn, can enable the pursuit of strategies that are potentially more productive in the long term, despite short-term costs or risks.

Conventional business governance often focuses on establishing boundaries and defining the separation of decision-making powers. In contrast, family business governance is often focused on establishing productive, procedural engagement across the system. Consultations among owners, directors, and managers permit a freer flow of ideas as well as speedier decision making. They also contribute to an ongoing alignment of interests and objectives over time.

The active participation of owners is the key to effective family business governance. Family ownership defines the values, vision, and objectives of the business. It articulates the financial goals and performance expectations that guide board and management decisions. Owners also provide an overall vision of the company that generally defines a business

strategy. This clarifies and focuses objectives across the system and helps in setting strategic constraints on board and management decisions.

Establishing a clear and shared understanding of the separate functions of the ownership, board, and management is vital to effective family business governance, all the more because family members often wear multiple hats, functioning as owners, directors, and managers.

While the direct involvement of the family on multiple levels complicates the system, it also provides an important link between the different areas of governance. This built-in link, combined with a positive development of family ties and relationships, can fundamentally change the trust that pervades the governance system. A well-functioning system helps in building trust within the family, and a good family, in turn, becomes an asset to the business because it enables each separate piece of governance to function better and add more value while remaining aligned with the other components of the governance system.

Stages of Family Business Development

Most family businesses begin with an entrepreneurial founder. Initially, the founder embodies the governance system, being the all-powerful owner and operator of the business. Founders sometimes make use of advisory boards, but they generally retain all decision rights. In many cases, the chief challenge of founders is deciding how to sustain their family business through succession. Some founders seek a single heir who can re-create the concentrated power of the owner. More, however, see the business as a collective inheritance and divide it among members of the family. Live example of Lakshmi Niwas Mittal who is heading the multinational steel company 'Mittal Steel' which his father 'Mohan Mittal' began. Mittal has grown the family business into one of the largest steel companies in the world, with steel making facilities in 14 countries and employing more than 150000 people. The Indian born, British based steel magnate is the third richest man in the world in 2005 according to the Forbes business magazine. Another example of entrepreneurial founder is Dhirubhai H. Ambani, the founder of Indian Reliance Group Conglomerate.

When ownership passes down across generations, it passes through distinct stages. The first stage is the sibling or family partnership, with parents sharing ownership with their children. Eventually, the involvement of the parents ends, and the siblings come to share ownership in a partnership spirit. They must

decide among themselves how to govern the business; often, this is described as the "kitchen table" period. The siblings can sit down together and consult informally, and sometimes they form a board to help build consensus for strategy. Roles may begin to separate at this stage, as some siblings may be active in the business while others are not. From this point on, the level of trust in the family often determines how formal governance practice becomes. Kokilaben Ambani, wife of Dhirubhai H. Ambani, the deceased founder of the Reliance Group amicably resolved the power feud between her sons (Mukesh and Anil) by dividing the business between them.

The third generation succession often involves a diverse group of cousins. This generally changes the scale of the family and differentiates family roles further. Family members may continue to be involved in management, the board, and ownership. Ownership holdings can become increasingly variable in size, with some remaining quite concentrated. Family members can be active to varying degrees in the business and governance, and their level of involvement may not necessarily reflect their level of economic interest. These complications generally lead to the development of more formal governance practice. When majority ownership moves outside of management, the board will often take on more of a fiduciary characteristic. The extent to which trust is cultivated directly between the controlling owners and the leaders of management often determines how formal governance practice becomes at this stage and whether the family can continue to create effective agency in governance.

The next family succession causes another significant change in ownership. At this stage, the development of family governance, which functions in parallel to business governance, is often an added feature of an increasingly formal and complex governance system. Family members may continue to be involved across the governance system, linking ownership, the board, and management. Often, the business at this stage has become a holding company, creating the need for a board that can strategically manage a portfolio of businesses.

The Evolution of Family Business Governance

As business grows, it becomes increasingly complex, creating its own demands for a more formal organizational structure. While adapting governance practices to the emerging needs of families and businesses as they grow is a very complex and challenging endeavor, over time it is also unavoidable.

Unity of Ownership and family Governance

Families need to organize their ownership and work to strengthen their ownership commitment in order to achieve the benefits of concentrated ownership and satisfy issues of Corporate Governance. To do so, business family should develop a family governance system.

Family governance often begins with informal family meetings at which the values and hopes for the business are articulated. In order to assure inter-family harmony, the family educates itself on relationship skills, such as communications, conflict resolution and decision-making.

As the family grows, family governance can become more documented in the form of a family constitution. This is a comprehensive statement of the family's values, purposes and principles comprising a set of policies to address family business issues such as employment, contracts, board selection and dividends. It also includes a shareholders' agreement, which defines the legal rules of ownership and redemption.

Of course, not all families need a full fledged constitution. For example, the Mogi family of Japan, producers of Kikkoman soy sauce, has had a simple statement of 12 philosophic principles that has served it well for more than 100 years.

Independent Board in Family Businesses

Family owned entities are pervasive in India. We have Tata's, Birlas, Modi's, Ambani's etc dominating our economy. Further these families show little interest in giving up their control in better interest of public. For example, Birlas are fighting tooth and nail against Lodha's for control over Priyamvada's assets. Therefore it is important for the government to pay special attention to enforce Corporate Governance in family owned entities. Besides Government, the Family owned entities by themselves have many advantages if they follow a modern approach to Corporate Governance and adopt these new mechanisms in their companies. By setting up an Independent Board, the company will have following advantages:

1. *Credibility with Financial Institutions*

A family controlled company with truly supervisory governance impresses financial institutions. A primary concern of all lenders to family business is how the loan will be repaid in the event of the death or disability of a new owner/manager. There should be a forum and a process to manage the

process of management succession and to ensure that the best interests of the business continue to be the primary criterion for decision making. Moreover, knowing that a board is engaged in strategic review of operations or perhaps strategic planning, gives "comfort" to the bank/Financial Institution that the borrower is prudently managing his/her business affairs.

2. *Disaster Management*

In case owner/ manager of the family owned entity meets some accident or unpredicted death, there will be a severe jolt to the operations and directions of the entity. The absence of a supervisory Board of directors magnify problems faced by the family members who survived this tragedy. In such case, the Board can serve as a mentor to the new generation family members.

3. *Strategic Planning*

Access to other owner/managers of similar enterprises as well as to academics and advisors, who serve on the board of directors or council of advisors, is often the most effective way for owner/managers of family controlled enterprises to overcome their resistance to strategic planning.

Type of owners

There are several options to owners: they could be operating owners; governing owners; active owners; investing owners; or passive owners. The emphasis in these types is often a function of the generation of the family business. In the first and second generation, most families are operating owners, meaning they work in management full time. In later generations, as the family grows bigger the majority of owners become less involved in the day-to-day running of the company. For example, the German company Haniel has several hundred family shareholders and, by family policy, none of them is permitted in management.

Investing and passive owners are generally only interested in their economic returns. Thus, these businesses become, in effect, no different from any widely held, listed company.

Still, non-management family owners can add significant value in many ways. Some business families can be governing owners who are very involved in the business through conscientious board roles.

The Murugappa Group, an Indian conglomerate, carefully and thoughtfully defined the function of the

five governing owners who sit together on the company's holding board. They are cultural ambassadors throughout their companies and spend a lot of time with their non-family CEOs and executives to provide support and to assure succession. They carry fertile group competencies, such as technology, external contacts and human resource policies across their portfolio. And they represent the family on all their company's subsidiary boards.

All family owners, even if they do not have a position on the board, can add value as active owners. These are involved and responsible contributors, who spend time to understand the business in order to provide informed opinion on management and board decisions. This strengthens the confidence and courage of management and protects against disloyalty. Thus, involved owners deepen their emotional commitment and pride in the business.

Responsibilities of owners

For the family owners, there are four broad responsibilities:

1. *Defining the values that shape the company's culture*

Many families, such as the Bonnier media company of Sweden and Cargill of the US, have regular sessions between owners and managers to discuss important issues. Hatfield Quality Meats, a meat producer based near Philadelphia, has more than 200 family shareholders. It goes further than many of its peers by putting into practice and measuring its core values, including safety, energy, waste conservation and community support.

2. *Owners set the vision*

Family owners establish the parameters and boundaries for management strategies. They give instructions to the management. They may define the geographical scope of the business, for example, whether to become global and expand the family's horizons.

3. *Owners are responsible for the financial targets.*

Owners propose goals for growth, risk, liquidity and profitability. The Board evaluates these aims for feasibility and consistency. The four goals force the owners to grapple with the inevitable trade-offs in expectations. In so doing, the family gets a better insight into the company which, hopefully, unifies it and leads to

appropriate expectations.

4. *Owners elect the directors and design the Board.*

A good Board should be varied in its make up and should deal with the following issues:

- Should the Board have independent non family directors on the Board? If so, how many members and with what qualifications ?
- Should the family be represented on the Board? If so, by how many, and how should they be selected ?

A research in North America and Western Europe found that less than 25 percent of all family controlled businesses with more than 500 employees have at least three outside directors. In most developing economies like India, outside directors are less prevalent.

Most companies without active Independent Boards say they never considered establishing one, they feared losing control, or they doubted they would be able to attract high quality, non family directors. In fact, more family businesses need to recognize the benefits of a good Board and assure themselves that they can attract directors and retain control.

CONCLUSION

For well established large business families, maintaining ownership is not the ultimate end. Instead, the family's unity and commitment are most strengthened by other motivations. For example, they may rally round a social purpose for the company, like the owning family of Roche, the Swiss pharmaceutical company, which believes in the life-saving innovations of medicine.

Or they might focus on a family foundation and harness the financial success of the company to make a difference in society. For example, the Belmont family of Peru supports economic security opportunities for women by employing thousands of them to sell their company's health and beauty products across South America. What is more, through their family foundation, they offer the women educational scholarships.

These families are more than business owning families – they are enterprising families. In other words, they work together for a collective purpose that unites them emotionally as well as economically.

The real backbone of good family business governance is the purpose and governance of the family itself. It is their commitment to family unity that motivates them to be effective owners and to support their business for the long term.

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EMERGING AVENUES & COMPANY SECRETARIES (BPO, KPO AND LPO)

MONIKA GOEL*

Globalization is a new, unprecedented phenomenon which has affected the present generation to a much greater extent. If we compare the three aspects of economic globalization viz. Trade, International Finance and Foreign Investment in the Pre World- War I scenario with today, we find that earlier 16 most industrialized nations controlled nearly 21% of the world trade, and while that figure has not undergone any major revision, a major difference is that developing countries today constitute an important share (22%) when it comes to trade of manufactured products, especially in the still infant area of IT services. Now, private investment (in the form of FDI) forms a major chunk of investment as opposed to the State's investment in earlier times.

If we glance through India's reform story, which has caught the imagination of the world, we find that our merchandise exports crossed the US \$ 60 billion mark in the 10 months of the current financial year (2004-2005), having reached US \$ 61 billion during April 2004 to January 2005, which was 26 % higher than in the corresponding period of the previous financial year. India's merchandise exports should therefore exceed the target of 16 % growth set for the year to reach a level of around US \$ 75 billion. With the high growth achieved despite strengthening of the rupee vis-à-vis the US dollar and the overall impact of rise in fuel prices on competitiveness, the country is expected to double its percentage share of world merchandise trade by increasing its exports to US \$ 150 billion by 2009 which is one of the major objectives of our Foreign Trade Policy 2004-2009.

However, it is in the second and third aspect viz. International Finance and Foreign Investment - that we come across a brave new world of globalization. In the earlier times, International Finance related diplomacy

was very intimately connected to power equations. Even if all the reserve currency of all the central banks of earlier times were to be pooled together, they would still be insufficient to finance even a day's transactions of the foreign exchange market of the present times. Thus, today 98% of international trade is trade in currency carried on by Private Intermediate Traders (creating largest number of jobs in this area); and it is precisely this dimension that finds no parallel in the history of humanity. It is very difficult to analyze how this process went on to acquire such leviathan dimensions. It is like a black box; everybody can see the input and the output; however what happens inside is never known. The new form of International Finance emerged when U.S.A. liberalized its capital flows and introduced complete currency convertibility. Since then trade in foreign currency has assumed monstrous proportions.

On the FDI front also India is making slow but continuous growth. The data given below provides an overview of India's FDI scenario¹ :

Table I
FDI by year in India

Year	FDI Projects	**Capital Investment US\$
*2005	368	\$10.18 Bn
2004	685	\$19.44 Bn
2003	456	\$8.22 Bn

* Data for 2005 is up to the month ending September.

** Capital Investment data is not captured for all FDI projects in India.

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1. Source : www.locomonitor.com.

Table II
Top multinational companies in India

<i>Company</i>	<i>Projects</i>
Cognizant Technology Solutions	14
LG Electronics	14
Intel	12
Bose	11
Hewlett-Packard (HP)	10

Table III
FDI projects by industry cluster in India

<i>Industry clusters</i>	<i>Projects</i>
Information and Communication Technology (ICT)	615
Electronics	227
Business & Financial Services	226
Heavy Industry	141
Transport Equipment	119
Property, Tourism & Leisure	86
Light Industry	70
Life Sciences	68
Chemicals, Plastics & Rubber	61
Consumer Products	54
Food/Beverages/Tobacco	48
Logistics & Distribution	43

Table IV
Source Country of Multinationals investing in India

<i>Source Country</i>	<i>Projects</i>
USA	839
UK	205
Germany	99
Japan	79
France	53

It is evident from the data above that the maximum number of FDI projects in India is in the Information and Communication Technology (ICT) and three out of top five multinationals in India belong to ICT sector.

India is emerging as the preferred offshore destination for organizations across the world for outsourcing on account of its following attributes;

1. Its cost effectiveness, costs being a tenth of what it is in the US as a result of very low salary levels, not very expensive real estate, etc.
2. Availability of highly educated professionals and other skilled workforce with strong work ethics as well as capabilities to provide high quality work.
3. Robustness of its IT and other infrastructure including emergence of high bandwidth telecom networks as well as technological support.
4. India's unique geographic positioning which enables a 24x7 service as well as a reduction in turnaround times by leveraging the time zone differences.
5. Significant political patronage in the promotion of outsourcing industry.
6. Applicability of Tax holidays on profits generated from this industry.

Government's Support to the IT Enabled Outsourcing (ITES) market in India

Recognizing the growing importance of the business process outsourcing, the Government of India has introduced various policy concessions and initiatives to accelerate the growth of the IT-enabled outsourcing market. Spearheaded by associations such as National Association of Software and Service Companies (NASSCOM), the Indian software and services industry has also taken various steps to ensure that India becomes the global hub for IT-enabled outsourcing in the future. Some of the steps taken by the Government and industry for the ITES/BPO sectors are as follows:

1. In May 2002, the Government of India accepted the recommendations of NASSCOM and removed certain procedural bottlenecks that were hampering the growth of the Indian call center industry.
2. The Government of India (Central Board of Direct Taxes - CBDT) allowed total income tax exemption on the export of IT enabled outsourcing services under Sections 10A/10B of the Income Tax Act, 1961. These IT enabled products or services are:
 - (i) Back-office Operations
 - (ii) Call Centres

- (iii) Content Development or Animation
 - (iv) Data Processing
 - (v) Engineering & Design services
 - (vi) Geographic Information System Services
 - (vii) Human Resource Services
 - (viii) Insurance Claim Processing
 - (ix) Legal Database
 - (x) Medical Transcription
 - (xi) Payroll
 - (xii) Remote Maintenance
 - (xiii) Revenue Accounting
 - (xiv) Support Centres; and
 - (xv) Web-site services
3. Foreign Direct Investment (FDI) upto 100 percent is permitted in this industry.
 4. Permission of duty-free imports of capital goods (under the Export Promotion Capital Goods Scheme) for such companies.
 5. The Government has promoted several Software Technology Parks (STPs) which provide ready-to-plug IT and telecom infrastructure. STPs also allow single-window clearance for all regulatory compliance issues. Currently, several STPs have been established across the country.

Floodgates of opportunities have been opened for company secretaries in various outsourcing industries. It will be a worthwhile exercise to deliberate upon the relevance of these industries viz Business Process Outsourcing (BPO), Knowledge Process Outsourcing (KPO) and Legal Process Outsourcing (LPO) for the profession of company secretaries.

BUSINESS PROCESS OUTSOURCING (BPO)

Over the last few years, outsourcing of business processes has been gaining popularity driven by the fact that US firms have been enjoying much success from adopting this business strategy. European organizations have increasingly been focussing on what they identify as their core competencies and have been looking to reduce costs while maintaining high levels of quality for non-core activities and processes. To this end, two broad approaches had developed. One, to centralise the non-core processes into an in-house shared service functions to derive benefits of centralisation through an in-house process or through a wholly owned subsidiary. Two, to identify an acceptable third party service provider who will handle the processing work. The current economic

climate has encouraged the latter trend as the organizations continue to look for more innovative ways to improve efficiency and cut costs in order to survive the turbulent marketplace. Hence, the business process outsourcing.

As per the figures available from NASSCOM the Worldwide spending on IT/ ITES totaled approximately US\$ 712 billion in 2001. IDC projects that by 2006, the potential ITES-BPO market may increase to US\$ 1.2 trillion, with an overall compounded annual growth rate (CAGR) of 11 percent. While traditionally the key driver for ITES-BPO activities has been cost reduction, companies are increasingly viewing these services as strategic and essential elements for overall corporate growth.

Relevance of BPO for Company Secretaries

The BPO sector seems to have various opportunities which can be capitalised by the company secretaries. Apart from the work relating to the mergers & acquisitions in BPO sector and Income Tax related matters, provisions of FEMA are also quite involved as more and more foreign multinational companies are entering into this sector, where role of the professionals like company secretaries come into picture. Besides, as far as practising company secretaries are concerned, in the words of outsourcing they are out and out third party service providers. The services rendered by them e.g. consultancy services, secretarial audit, various certifications, reports, issuance of various certificates, etc. and other matters relating to corporate laws are generally outsourced by the corporates on a large scale.

With reference to the BPO, if it is seen in detail, the outsourcing of work relating to 'Transfer and Dematerialisation of Securities' is pretty common practice among the large public companies. Instead of carrying out the aforesaid work in-house, companies use to appoint a "Registrar and Share Transfer Agent" (RTA), which happens to be a BPO company. The RTAs carry out the work relating to transfer and dematerialisation of securities and charge the companies as per the terms and conditions of the agreement entered into between the company and itself. What is important to mention here is that, looking at the skill-set and expertise, qualified company secretaries can promote a company (i.e. a BPO company) with its main objective to undertake the share registry work and other objects which are allied and incidental thereto, which will perform as RTA to various corporates. Even to see it other way round, the companies which happen to outsource the work relating to transfer and

dematerialisation of securities, will certainly prefer to hire such kind of RTA which is led by the professionals who have requisite background and specialization in the field.

Similarly, there may be other areas too which can be explored in the present trend of BPO, which is seen as a tool by the corporates to reduce the costs incurring on account of carrying on the non-core processes in-house.

KNOWLEDGE PROCESS OUTSOURCING (KPO)

KPO covers the outsourcing of higher-end processes such as research and analysis in industries like data and market research, financial research and planning, engineering, medical content, animation and design and legal services. Knowledge Process Outsourcing is another industry which is growing very fast and it is estimated by CII that the global KPO industry will touch US\$ 17 billion mark by 2010, of which US\$ 12 billion would be outsourced to India. In India, the segment is expected to employ over 250,000 professionals against the current 25,000 professionals. It has been reported that Knowledge Process Outsourcing will eventually outstrip Business Process Outsourcing in revenue.

In Business Process Outsourcing, clients provide the business process requirements and the outsourcing service provider in India follow the needs of the client. But in Knowledge Process Outsourcing Indian companies will be asked to provide vertical business segment driven specialized knowledgebase. It needs vertical business alignment and strong networking with specialized consulting firms. A client in KPO will not look at dollar figures but will be mainly concerned with quality of services. This can be achieved by moving up in the value chain besides augmenting human resources and domain knowledge.

Although very few Indian companies are working in this space now, KPO will be one of the major segments of the outsourcing business in terms of creation of new jobs and generation of billions of dollars in business. With India having quality human resources it is all set to become the hub for Knowledge Process Outsourcing. Professionals from diverse fields are therefore finding interesting career options in this sector. In its recent study-'India in the new knowledge economy'-the CII estimated that the services sector would grow at more than eight percent and its contribution to GDP would be above 51 percent. The study affirmed that India's transition from being a BPO destination to a KPO destination was imminent. Areas with significant potential for KPO include

pharmaceuticals, biotechnology, information technology, legal services, intellectual property, research and design, and development of automotive and aerospace industries.

Relevance of KPO for Company Secretaries

Knowledge Process Outsourcing requires specialized knowledge in respective verticals and the country's professionals must be geared to address the manpower demand. Unlike BPO companies, KPOs lay a lot of emphasis on educational qualifications. The work in a KPO is very academic oriented wherein employees have to be fluent in processes with sound academic base of the related field. By virtue of their expertise and in-depth knowledge of corporate laws and commercial and trade practices company secretaries should be able to provide research solutions in the various areas of corporate activity, investment research and intellectual property services to companies worldwide. Following areas may be specifically explored by company secretaries:

- **Foreign Exchange Research and Forecast:** Company Secretaries having a sound knowledge of forex and treasury management can provide accurate and reliable long term forecasts for any currency. These forecasts are very useful for long term investors and corporate treasurers in planning their hedging and investment policies. Besides, company secretaries can also provide mid office and back office support to the foreign exchange department of various institutions overseas.
- **Intellectual Property :** Advising on commercialization, valuation, and enforcement of IPRs and legal issues surrounding the rights of ownership of ideas, inventions, trade secrets, processes, programs, data, formulae, patents, copyrights, trade secrets, or trademarks and the application or registration thereof.
- **Financial Management and Planning :** It includes reviewing the company's business plans and annual budget and analyze and summarize various financing proposals sent to the company. Some of the main functions include:
 - (i) Assessing the financial markets;
 - (ii) Preparing a competitive analysis of the industry;
 - (iii) Preparing and reviewing the corporate budget and business plan;

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- (iv) Gathering, analyzing, and summarizing pertinent treasury information in report form;
 - (v) Developing sinking fund strategy for repurchase of company bonds;
 - (vi) Preparing for agency rating reviews; and
 - (vii) Analyzing, designing, and implementing a variety of computer-based information systems for the worldwide treasury applications.
- **Working Capital Management** : It includes:
 - (i) Establishing accounts receivable guidelines;
 - (ii) Establishing credit, and collections guidelines;
 - (iii) Developing contingency plans;
 - (iv) Monitoring vendor financial conditions; and
 - (v) Reviewing and implementing external regulations.
 - **Risk Management** : Risk management is associated with hedging- the reduction in or elimination of a type of risk. For example: The price risk of a commodity, or market risk of investing. Some types of jobs that utilize this skill are:
 - (i) *Trader* : Executes trades in contracts or exchanges of offset portions of the position exposure faced by the firm.
 - (ii) *Position Manager* : Analyze the net exposure of the firm's positions and develop strategies to manage that exposure.
 - (iii) *Research Director* : Directs teams of quantitative analysts who design new products and research areas that appear fertile.
 - **Personal Financial Planning** : Process of determining whether, and how an individual can meet his or her life goals through proper management of financial resources. This is a relatively new field. Some of the duties include:
 - (i) Cash flow and budgeting analysis;
 - (ii) Insurance needs;
 - (iii) Investment management;
 - (iv) Analysis of debt;
 - (v) Portfolio analysis;
- (vi) Retirement planning;
 - (vii) Forecasting retirement benefits and costs; and
 - (viii) Estate planning.
- **Investment Analysis** : There are two types of investment analysis: Security Analysis and Portfolio Management.
 - (a) **Security Analysis** : Specializes in the evaluation of securities and other investments in asset classes. This includes:
 - (i) Analyzing and staying current on companies under their responsibility;
 - (ii) Disseminating information and stock recommendations to the clients; and
 - (iii) Satisfying investment needs.
 - (b) **Portfolio Management** : To work with individual or institutional investor and to oversee portfolios consisting of equities, fixed-income securities, and other multiple asset classes. This includes :
 - (i) Making final decisions on whether to trade a security and then direct the trades;
 - (ii) Specializing in an asset class;
 - (iii) Determining appropriate investor objectives; and
 - (iv) Establishing portfolio policies and strategies
 - **Stockbrokering** : Investing in the stock market for individual or corporation. You must be a member of the stock exchange to conduct transactions. This includes :
 - (i) Advising and counseling clients on appropriate investments;
 - (ii) Explaining the workings of the stock exchange to clients;
 - (iii) Sending orders out to the floor of the securities exchange by computer or phone; and
 - (iv) Transferring stock titles
 - **Insurance** : This is another risk management area. The main goal is to protect the company from the adverse financial impact of significant unexpected losses using self-insurance,
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- captive insurance, loss control, and safety techniques. This covers
- (i) Planning and establishing long-range risk management objectives;
 - (ii) Developing, implementing, and maintaining an overall risk management program;
 - (iii) Maintaining effective communication with other departments that provide assistance in the administration of risk management; and
 - (iv) Reviewing the effects of mergers, acquisitions and joint ventures.
- **Real Estate** : Besides other things, it primarily includes mortgage analysis i.e to
- (i) Handle all matters related to the production, analysis, and negotiation of application for the acquisition of conventional mortgage loans and real estate investments;
 - (ii) Negotiate terms, conditions, interest rates, etc. to obtain a flow of acceptable applications;
 - (iii) Analyze client's financial status;
 - (iv) Inspect property under consideration;
 - (v) Assist in the negotiation of the final commitment terms and conditions; and
 - (vi) Prepare correspondence on all aspect of application processing.
- **Commercial Banking** : There are many areas within the commercial banking area that are open to people with backgrounds in finance. Some of these areas include:
- (i) Commercial Loan Analysis;
 - (ii) Loan compliance and documentation;
 - (iii) Lending Assistants;
 - (iv) Cash Management Representatives; and
 - (v) Trust Management.
- **Investment Banking** : To
- (i) Advise their clients on high-level issues of financial organizations;
 - (ii) Manage the issuance o bonds;
 - (iii) Recommend and execute strategies for taking over and merging with other companies; and
 - (iv) Handle selling a company's stock.
- **Advising on international investments:** Advising on International IPOs-ADR's, GDR's, Sponsored ADR's & GDR's, preferential allotments, sale of stake, FDI, debts, FCCBs, exchange traded derivative instruments, mutual funds, money market instruments, credit appraisal, wealth management, provident funds, pension funds and compliance with the statutory requirements thereto.
- **Corporate Restructuring** : To be engaged in the areas of advising, valuation and enforcement of mergers, acquisitions, takeovers, leveraged buyouts, creeping acquisitions, joint ventures and foreign collaborations.
- **Secretarial Functions** : Includes Board approvals, documentation of minutes, research and budgeting, approvals from regulatory bodies and filing of documents, listing with stock exchanges, compliance with procedures, investors grievances, allotments, transfer, transmission, maintenance of statutory records, devising of investment policies, internal audit of the processes and operations, annual returns etc.
- Besides the above company secretaries can find their way in the privatization programmes of Governments, international funding of projects by international organizations, NGOs and other DFI assignments.
- All this requires a basic interest and knowledge in specific domains besides an aptitude for working with data and information. Company Secretaries can establish themselves and can prove to be an edge better than other professionals in terms of better understanding and hands on experience of relevant laws relating to tax, securities, investment, financial management, WTO, etc. Rating agencies like S&P, Moody's , Fitch etc , consultancy firms like Mckinsey, BCG etc are resorting to KPO's for specialized domain research. This is all happening because of technological advancements and ease of travel. Internet and fast data transfer modes are making the world one place without any barriers.
- Company Secretaries having knowledge of inter country laws, breadth of coverage, domain expertise, location advantage, compliance with regulator standards and risk management will be able to differentiate themselves in KPO industry and sustain a competitive advantage in the future.

LEGAL PROCESS OUTSOURCING (LPO)

Legal Process Outsourcing is a far more sophisticated form of off shoring. It helps law firms to increase their service value by outsourcing low end legal work and freeing attorney's to concentrate on specialized legal services. It ranges right from filing patents to drafting transnational contracts to creating necessary information back-up for global corporations in litigations and providing support in contract management i.e. a wide range of legal work, bringing in similar scale of economies that business process outsourcing brings to companies. There is lack of clarity in what constitutes legal services in the outsourced mode. This has created different assessment of the current market size and the future potential India holds in the international marketplace, given its advantages. As per estimates only US has a \$200 billion market for legal outsourcing. Significantly, while there are different projections as to what is in store for the Indian market place, one estimate by Forrester puts this at about \$3.9 billion by 2010.

Patent-related services can be offered from outsourced centres at a fraction of the cost. That means for the same amount, a US company can file for more patents. If what can be offered under the ambit of legal services is analyzed, we are just looking at the tip of the iceberg.

Relevance of LPO for Company Secretaries

Company Secretaries having wide and in depth understanding of intellectual property, taxation matters, secretarial practices and legal drafting have host of opportunities for legal outsourcing assignments. There are a number of opportunities in the area of compliance with US GAAP.

In general the following activities are covered under legal process outsourcing:

1. Preparing and processing a variety of legal paperwork including court pleadings and correspondence, such as opinions, proceedings, ordinances, contracts, orders, motions, information, complaints, warrants, subpoenas, commitments, indictments, decisions, requests for investigation, extraditions, affidavits, briefs, jury instructions, dismissal sheets, and other documents.
2. Preparing legal papers and legal documents in standardized forms and formats from general information.
3. Maintaining files of correspondence and legal documents.

4. Comparing forms and legal references with reference books to ensure that they are accurate.
5. Preparing general correspondence, claims, requisitions, personnel forms and other material.
6. Maintaining records of cases, court calendars, case histories, and court dates.
7. Maintaining and preparing routine statistical reports.
8. Transcribing notes, memos, legal documents and minutes of meetings from tape.
9. Taking and transcribing oral dictation of notes, memos, legal documents, and minutes of meetings.

Some other areas open for legal outsourcing are:

- **Legal BPO** : In today's competitive, worldwide legal market; what is required is effective legal support provided by a combination of legal capabilities: the ability to deliver highest quality, clearly stated service, deep knowledge of client markets and their individual commercial and regulatory standards; acceptance by regulators; and perhaps most importantly, common sense understanding of the client's commercial objectives.
- **Legal Transcription Services** cover preparing legal documents from written or dictated information. It also includes drafting and filling legal documents, calendaring and tracking other important works. In general the informations from courtrooms is recorded into a tape or into a digital voice processing system. So Legal Transcription refers to the process of transferring information from recorded dictation to hard documentation using transcriptionists and computer word processors.
- **Document Management Services** : these provide an organization with the tools to create, manage, control, and distribute electronic documents reducing the amount of time spent in retrieving documents. It can provide better security provisions, audit trails showing who has modified or used documents, and increased ease of creating and using boilerplate documents.
- **Deposition Summaries** the work of summarizing depositions in a very accurate manner and easy language.

- **Legal Billing** includes processing attorney time sheets and related billing functions and at the same time providing clients and law firms with meaningful cost information on legal services in a uniform and standardized manner.
- **Legal Coding** covers developing client project based on an understanding of legal coding principles, rules, conventions and terminology using the latest state-of-the-art software used by major law firms. Coding should be based on uniform standards being promulgated and developed within the legal profession.
- **Paralegal Services** which include processing claims, data entry, proofreading services, document review, deposition digesting and shepardizing cases.
- **Legal Translation** includes preliminary review of foreign language documents in discovery, and research on foreign language legal texts and its interpretation.
- **Data Entry Services** covers taking hard copy data, like surveys, mailing lists, warranties, coupons etc., and digitizing it into a workable database.
- **E-filing services** uses the internet for the filing

of briefs, pleadings, motions, and other lawyer-generated documents for the courts.

CONCLUSION

Such continuous exploration of scope of practice demand a brilliant focus on emerging opportunities, strengthening each link in the service-delivery mechanism and a clear-cut vision to deliver value added services. It is to be appreciated that the future of India lies in outsourcing industry. This is the direction where the leading professionals are looking at. It is high time that company secretaries sharpen their capacities and develop strategies for the leadership position in these opportunity zones.

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MODERNISATION OF COMPANY LAW FOR GLOBAL COMPETITIVENESS

ALKA KAPOOR*

INTRODUCTION

Most of the countries in the world today including UK, Hong Kong, Singapore, Australia and Canada are in the various stages of modernizing their company law. A fair modern and effective framework of company law is crucial to the performance of any economy and society. To achieve competitiveness, it is essential that while the law must balance the needs of many interests, for example, shareholders, directors, employees, creditors and customers, it must also avoid unnecessary burdens.

In the current national and international scenario of complex business operations there is a need for simplifying corporate laws so that they are amenable to clear interpretation and provide a framework that would facilitate faster economic growth. It is also being recognised that the framework for regulation of corporate entities has not only to be in tune with the emerging economic scenario, it must also encourage good corporate governance and enable protection of the interests of investors and other stakeholders.

Growing emphasis on good corporate governance, corporate social responsibility and good corporate citizenship is predominantly influencing company law reforms the world over. Modernization of company law has in fact become a part of the drive to facilitate enterprise, enhance the attractiveness of the country as a preferred destination to do business and foster business competitiveness. The overall objective is to achieve a simple, consolidated and accessible company law. Simultaneously, worldwide the Company Law reforms are focusing on transparency through enhanced disclosures and increased accountability on the part of corporate owners while at the same time providing a flexible regime for small and medium businesses. Additionally, the reforms aim at cutting back on overly

regulatory intervention thus providing companies operating flexibility to tune in conformity with changing environment.

The litmus test lies in the harmonization of company law with that of global standards, the process which has been started about a decade ago in most countries, so as to achieve global competitiveness.

COMPANY LAW REFORMS IN UNITED KINGDOM

Company Law in U.K. is currently undergoing major reform under the Company Law Review (CLR), which seeks to modernize the legal framework in which companies operate. In 1998, the Government commissioned the Company Law Review Group, an independent group that comprised experts, practitioners and business people to take a long-term fundamental look at core company law and see how it could be brought upto date. The CLR conducted a thorough review and assessment and provided the essential blue print in the form of a Report. As a response to the final Report of the Company Law Review, the Government brought out White Paper on Company Law 2002, introducing which the then competition Minister, Melanie Johnson stated "Our current company law is creaking with age and needs to modernize and reform. A thorough overhaul is needed to make the law clear and accessible".

The White Paper 2002 evoked huge response. Taking into consideration, the suggestions received, the Department of Trade and Industry released the UK White Paper on Company Law, 2005. This white paper, which contains draft clauses for Companies Bill was released in March, 2005 inviting views. The new Companies Bill runs into 190 pages, has 11 main parts and 298 clauses. It also includes draft model articles for private companies limited by shares.

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Key themes of the White Paper 2005

Proposed changes in the Company Law Reform Bill consist of 4 key themes:

- *Enhancing shareholder engagement and a long-term investment culture*

Shareholders are the lifeblood of a company, whatever its size. There is therefore, a need to promote wide participation of shareholders, ensuring that they are informed and involved, as they should be. Also, decisions should be made on the longer-term view and not just immediate returns.

- *Ensuring better regulation and a "Think Small First" approach*

Although the vast majority of UK companies are small, company law has been written traditionally with the large companies in mind. The law should be made easier for all to understand and use and should remove unnecessary burdens on smaller companies, which are so critical to the economic health of the country.

- *Making law easier to set up and run a company*
- *Providing flexibility for the future*

Remove unnecessary burdens on directors and preserve Britain's reputation as a favoured country in which to incorporate and operate.

Company law is not static. There is, therefore, a need to introduce a new reform power to allow updating and amendment as circumstances dictate, subject to rigorous safeguards for full consultation and appropriate Parliamentary scrutiny.

Pillars of responsibility enshrined in White Paper 2005

As a result of Enron and other recent corporate scandals there has been a significant push in U.K. to oblige companies to report clearly about their business actions. Government has taken the opportunity of reforms to create laws that protect society from increasingly powerful companies and hold them accountable for their actions both at home and abroad, Corporate reporting of social and environmental aspects has also become mandatory under the new Bill.

Accordingly the three pillars of responsibility proposed to be imposed on corporates are :

1. *Mandatory Reporting*: Companies shall report

against a comprehensive set of social, environmental and economic performance indicators with which they can benchmark and ultimately better manage their operations and performance in the UK and abroad.

2. *Directors' Duties* : Current directors' duties have been expanded to include a specific duty of care for both society and the environment, in addition to their current financial duty to shareholders.
3. *Foreign Direct Liability* : Affected communities abroad should be able to seek damages in the UK for human rights and environmental abuses committed by UK companies or their overseas subsidiaries.

The rationale behind these three requirements is to establish a relationship of accountability between the two parties involved – the company and the stakeholder.

Highlights of major reforms proposed in the UK White Paper 2005

Company Formation

One person to be able to form any kind of company. Currently, only private limited companies can be formed by a single member.

Memorandum of Association (MOA)

Company constitutions shall be a single document, with simpler, clearer models for both private and public companies.

MOA shall only be a means to identify the persons who wish to form a company. This will be the only purpose of MOA. It shall state that –

- (i) subscribers wish to form a company;
- (ii) subscribers agree to become members and to take at least one share in the company; and

subscribers shall sign the MOA.

There will be no mention of objects clause implying that unless a company positively chooses to restrict its objects, its objects shall be unrestricted. Further, objects shall, in future, be in company's Articles. Therefore, any restriction in objects shall be contained in the Articles of the company.

Articles of Association (AOA)

Government shall specify model Articles for both private and public limited companies, the adoption of

which would be entirely a matter for the company. This provides flexibility to all companies to choose not to register their own Articles of Association in which case their articles shall be the model articles prescribed.

Members can choose to 'entrench' elements of company's articles. This means that members shall have a power to lay down stringent provisions for amendment of Articles say, unanimous resolution etc. However, such entrench clause should be included in AOA through a unanimous consent of members.

Change of Name of Company

In addition to the present circumstances, the name of a company may be changed in these three new circumstances :

- (i) Order of a Tribunal. It will be possible for a company to change its name if it was chosen to exploit another's company's reputation or goodwill (this is not a protection for trademarks); The tribunal will be constituted under provisions relating to opportunistic registration.
- (ii) Restoration to the register. A new provisions is introduced to simplify what happens when a company is restored to register. These will cover the possibility that, while the company was not on the register, its name was adopted by another;
- (iii) Any other means provided for by the company's constitution. This is a deregulatory proposal, a special resolution will no longer be the only means by which a company can change its legal name. (At present there are no restrictions on the method by which a company can choose its trading name, and the Bill does not change this.)

Simplifying the way companies take decisions

- Removal of the requirement for private companies to hold Annual General Meetings (AGMs) unless members want them. This provision shall also remove the requirement to lay down the accounts and re-appoint the auditors at a general meeting. Where private companies hold an AGM, the re-appointment of auditors will be decided by ordinary resolution.
- The notice period for all meetings, for limited companies will be 14 days.
- The extraordinary resolution will be abolished. Where a company's constitution requires an

extraordinary resolution, it will become a requirement for a special resolution.

- Simplification of the rules on written resolutions to make it easier for private companies to take decisions. The use of 'written resolution', akin to the postal ballot mechanism prevalent in India, has been permitted but restricted to private companies only. Private companies may pass a written ordinary resolution with a simple majority of the eligible votes and a written special resolution with 75% of the eligible votes. However, resolutions for removal of directors/auditor of a private company cannot be passed by written resolution.

Increased Transparency

- The current law requires companies to hold an AGM once a year and there can be a gap of 15 months between AGMs. The Bill requires public companies to hold their AGM within 6 months of the end of the financial year.
- Shareholders of quoted companies will have a right to propose a resolution to be moved at the general meeting where the accounts are laid within 15 days from the day the accounts become available.
- Shareholders will be able to require a scrutiny of a poll. The scrutiny will cover the activity of the company and its registrar, and examine the procedure for establishing the admissibility of votes and proxies. Shareholders of quoted companies will have a new right, if a certain specified minority so request, to require an independent scrutiny of any polled votes. Quoted companies will also be required to disclose on their websites and in annual reports the results of polls at general meetings.
- A registered auditor, not necessarily the company's own, will conduct the scrutiny.
- Proxies will have extended rights. Any proxy for a shareholder will be able to speak, vote on a show of hands as well as on a poll, and join with others in demanding a poll.
- Companies will be able to recognise, the rights of the holders of beneficial interests in shares at the request of the registered member. There will be some exceptions to this, for example, only the registered holder will be able to transfer legal title, to ensure that the shares are readily traded.

Share/Share Capital

- The requirement of the authorized share capital be removed on the basis that it is an unnecessary piece of regulation. It will however be possible for shareholders to include provisions with a similar effect in a company's articles if the special circumstances of that company make such restrictions important to the shareholders.
- Shareholders of both public and private companies will be able to approve an allotment of redeemable shares on terms that the directors determine. The terms and manner of redemption will need to be provided to the Registrar of Companies in the return of allotments.
- The share premium account can no longer be used to write off a company's preliminary expenses.

Directors

- Primary role of directors will be to promote the success of the company for the benefit of its shareholders as a whole.
- Director's general duties to be codified as proposed by the Company Law Review (CLR). Guidance to be given to new directors to cover the statutory statement of duties, requirements to provide information to Companies House, and key provisions such as the prohibition of fraudulent trading, as well as relevant aspects of insolvency law.
- A person may not be appointed as director of a company unless he has attained the age of 16 years. The Bill will remove restrictions on directors over 70 years.
- A company must have at least 1 director who is a natural person. This requirement is met if the office of director is held by a natural person as a corporation sole or otherwise by virtue of an office.
- Directors and Officers (D&O) insurance. Companies may:
 - indemnify directors against most liabilities to third parties; and
 - pay directors' legal costs upfront, provided that the director repays if he or she is convicted in any criminal proceedings or

judgments is given against him or her in any criminal proceedings brought by the company or an associated company.

- Every company director will be given the option of providing a service address for the public record with the home address being kept on a separate record to which access will be restricted. This will replace the present system under which only directors at serious risk of violence and intimidation can have their home addresses kept off the public record. The general effect of the current law appears to be to deter some people from becoming directors.

Reporting and Auditing

- Companies shall provide accurate, accessible information at reasonable cost.
- The current director's report to be replaced, for small companies, by a short, simple, supplementary statement.
- "Small" companies can claim the right to file "abbreviated accounts", with no profit and loss account and no directors' report, with the Registrar of Companies, while "medium-sized" companies can suppress their turnover and operating costs information. Only "large" groups are required to prepare consolidated accounts. Charitable companies are entitled to the full accounts requirement to be prepared by the directors.
- Reduction of the time allowed to file accounts to 7 months for private companies, and 6 months for public companies.
- Quoted companies to prepare a directors' remuneration report. They shall also publish their accounts on their website within 4 months from the end of year.
- A requirement for companies to prepare a cash flow statement.

Auditor liability and audit quality

- Enhanced auditors liability and tougher penalties for accounting offences. Seven years imprisonment for dishonestly failing to keep accounting records and penalty of seven years imprisonment and fine and both for defective accounts (currently this penalty is for two years).
- Shareholders to be able to agree to limit the auditor's liability for damages incurred by a company to such an amount that is determined

by the Courts to be just and equitable, having regard to the relative extent of responsibility of the auditor for the damage incurred. The auditor would continue to be fully liable for any fraud to which he or she was party and the existence of any limitation of liability would be shown in the company's annual financial statements. The auditor should also provide a list of all companies with which it has agreed on a limitation of liability in its own annual financial statements.

To improve audit quality and value, the following measures are proposed:

- Publication of audit engagement letters.
- Shareholders' rights to question auditors.
- Publication of auditor resignation statements.
- Audit lead partner's signature on audit reports.

Keeping the law upto date

- Those elements of company law that are likely to need regular amendment will be put into secondary legislation.
- The rule making body would also take over from the UK Listing Authority, regarding their responsibility to require listed companies to disclose their compliance with the Combined Code on Corporate Governance. It will also decide on reviews of the Code (which will remain non-statutory).

Other areas of reform

- The requirement for private companies to appoint company secretaries to be abolished (they will still be free to do so voluntarily).
- The law regulating companies incorporated overseas and operating in Great Britain to be simplified.
- Government to consult Alternative Dispute Resolution providers to increase awareness of and accessibility to forms Alternative Dispute Resolution as a way of resolving disputes between shareholders.
- The Government is considering restricting the use of companies' registers of members. It is considering an approach that would permit the companies not to provide copies of their registers if they are to be used for inappropriate purposes (an 'inappropriate purpose' is cited as the use of the data for marketing and selling

purposes). The Government is inclined to allow a company to have the right to apply to the Court for relief from the obligation to provide a copy of its register, while the courts would continue to have discretion to refuse to order access to the register.

E-communications

- Existing provisions of company law impose a number of requirements about the use of paper communications, which can prevent both companies and shareholders from enjoying all the cost savings and other benefits that sensible use of new communications technology can bring.
- The Government therefore intends to allow all companies, subject to shareholder approval, to be able to use electronic communications with shareholders. Electronic communications can be used where the resolution can be received in legible form, or a form that can be converted by the recipient into legible form. For example, a resolution can be passed through an e-mail or text message, but not a telephone call. Individuals will be able to request continued communication on paper if they wish.

Further UK Initiatives on Company Law Reforms

The Government has come out with a number of other legislations closely connected with the wider company law reform project. These include:

- (i) **Companies (Audit, Investigations and Community Enterprise) Act, 2004 the C(AICE) Act** which has been brought forward to ensure better oversight and stronger regulation of the accounting and audit profession, to increase investor confidence in company reporting and enforcement, and to strengthen powers to investigate companies. The Act encourages the development of the social enterprise sector by making it possible to form a new type of company, the "community interest company", whose profits and assets must be used for the benefit of the community.
- (ii) The draft regulations which will require all quoted companies to produce an **Operating and Financial Review (OFR)** have been laid. The OFR is a new form of narrative report in which companies will need to describe future strategies, resources, risks and uncertainties, including policies in relation to employees and

the environment where these are relevant to future strategy and performance. It is a step forward in improving company reporting and transparency and in promoting effective dialogue on the key drivers of long-term company performance. It also recognizes that in a modern economy, those who run successful companies need to develop relationships with employees, customers, suppliers and others which support long-term value creation.

- (iii) **Directors' Remuneration Report Regulations, 2002**, which require quoted companies to disclose and seek shareholder approval for their executive remuneration policies, and to disclose how remuneration relates to performance. Regulations act as a catalyst for increasing company accountability and effective shareholder engagement.

INDIAN SCENARIO

Companies Act, 1956 which provides the legal framework for corporate entities in India too is a mammoth legislation. As the corporate sector grew in pace the need for streamlining this Act was felt and as many as 24 amendments have taken place since then. Major amendments were made through the Companies (Amendment) Act, 1988 after considering the recommendations of the Sachar Committee, and then again in 1998, 2000 and in 2002 through the Companies (Second Amendment) Act, 2002. Unsuccessful attempts were made in 1993 and 1997 to replace the present Act with a new law. Companies (Amendment) Bill, 2003 containing important provisions relating to Corporate Governance and aimed at achieving competitive advantage was also introduced.

To frame a law that enables companies to achieve global competitiveness in the fast changing corporate scenario, the Government has now taken up a fresh exercise for a comprehensive revision of the Companies Act, 1956 albeit through a consultative process. As a the first step in this direction, a Concept Paper on Company Law drawn up in the legislative format was exposed for viewing on the electronic media so that all interested may not only express their opinions on the concepts involved but may also suggest formulations on various aspects of Company Law.

The response to the concept paper on Company Law was tremendous. The Government, therefore, felt it appropriate that the proposals contained in the Concept Paper and suggestions received thereon be put to

merited evaluation by an independent Expert Committee. A Committee was constituted on 2nd December, 2004 under the Chairmanship of Dr. J J Irani, Director, Tata Sons, with the task of advising the Government on the proposed revisions to the Companies Act, 1956 with the objective to have a simplified compact law that will be able to address the changes taking place in the national and international scenario, enable adoption of internationally accepted best practices as well as provide adequate flexibility for timely evolution of new arrangements in response to the requirements of ever-changing business models.

DR. J J IRANI COMMITTEE REPORT

Dr. J J Irani Expert Committee on Company Law has submitted its report charting out the road map for a flexible, dynamic and user-friendly new company law. The Committee has taken a pragmatic approach keeping in view the ground realities, and has sought to address the concerns of all the stakeholders to enable adoption of internationally accepted best practices. As one wades through the report, one finds an arduous zeal to ensure that flexibility is coupled with accountability and transparency. Be it the role of directors in the management of the company or the role of promoters at the time of incorporation or the responsibility of professionals in ensuring better governance, the report has made very dynamic and balanced recommendations. The Report of the Committee has also sought to bring in multifarious progressive and visionary concepts and endeavored a significant shift from the "Government Approval Regime" to a "Shareholder Approval and Disclosure Regime".

The Expert Committee has recommended that private and small companies need to be given flexibilities and freedom of operations and compliance at a low cost. Companies with higher public interest which access capital from public need to be subjected to a more stricter regime of Corporate Governance. Further, Government companies and public financial institutions be subject to similar parameters with respect to disclosures and Corporate Governance as other companies are subjected to.

New Concepts introduced

To attune the Indian Company Law with the global reforms taking place in the arena, the Report of the Committee has sought to bring in multifarious visionary concepts, which if accepted and acted upon will really simplify the voluminous and cumbersome Companies Act in the country.

One Person Company (OPC)

To encourage corporatisation of business and entrepreneurship, the concept of single person economic entity has been introduced in the form of 'one person company'.

It is recommended that :

- (a) OPC may be registered as a private Company with one member and may also have at least one director;
- (b) Adequate safeguards in case of death/disability of the sole person should be provided through appointment of another individual as Nominee Director. On the demise of the original director, the nominee director will manage the affairs of the company till the date of transmission of shares to legal heirs of the demised member.
- (c) Letters 'OPC' to be suffixed with the name of One Person Company to distinguish it from other companies.

The recommendation is in sync with the international practice as U.K., Australia, Singapore and many other countries provide that a company is capable of being formed with a single person and having one director. Even the neighboring country Pakistan has introduced the concept, albeit only for incorporation of private companies limited by shares.

It is also recommended that such companies should be regulated through a simpler regime so that the single entrepreneur is not compelled to dissipate his time and energy and resources on procedural matters. However, the OPCs should be permitted to be formed only by natural persons.

Small Companies

The law should provide a framework compatible to growth of small corporate entities and should enable them to achieve transparency at a low cost through simplified requirements. With this aim and to enable simplified decision making procedure by relieving small companies from select statutory internal administrative procedures, the Committee has recommended that such companies be governed by a simpler regime through exemptions which can be given in the form of a schedule to the Act. Such companies should be subjected to reduced financial reporting and audit requirements as well as simplified capital maintenance regime. Such companies should also be subjected to scaled down free structure. The definition of small companies may be based upon the gross assets comprising of fixed assets,

current assets and investments not exceeding a particular limit as also the turnover of the company concerned.

Simplified regulatory regime for small companies as proposed in U.K. white paper with its emphasis on 'think small first approach, also exists in many other countries including Germany, France, U.S.A. etc.

Limited Liability Partnership (LLP) – The 'unlimited liability' of partners has so far been the chief reason why partnership firms of professionals, have not grown in size to successfully meet the challenges posed today by international competition, WTO, GATT etc. As an alternative corporate business vehicle that has the benefits of limited liability but allows its members the flexibility of organizing their internal structure as a traditional partnership, the Committee has proposed the concept of LLP to be introduced.

In an LLP, while the LLP itself is liable for the full extent of its assets, the liability of the partners is limited. Partners are protected from vicarious liability i.e. liability arising from the incorrect decision or misconduct of other partners and employees not under their direct control. There is no recourse to attach the personal assets of other members except the member who is negligent. However, the liability of negligent partner remains unlimited. Also any new or existing firm of two or more persons can incorporate as an LLP.

LLP is the very suitable vehicle for growth of the service sector and specially for multi disciplinary partnership firms. It provides flexibility to small enterprises to participate in joint ventures and to access technology and to professionalise business in order to face increasing global competition.

The laws of U.S.A., U.K. and Australia permit formation of LLPs. Most LLP statutes provide that partners will be personally liable for their own negligence or malfeasance. In addition, most LLP statutes provide that LLP partners are liable for the negligence, wrongful acts and misconduct of any person under the LLP partner's "direct supervision and control", although the statutory terminology differs in this regard. Further, the most recent LLP statutes including those enacted in Colorado, New York etc., provide LLP partners with full protection from vicarious liability but limits LLPs to professional firms.

Though advocating the adoption of the concept of LLP in the Indian legal system, the Committee has recommended that a separate Act be brought about to facilitate limited liability partnerships. The concept need not be introduced in the Companies Act.

Independent Directors

Though the concept of independent directors is not new, it has so far been enshrined in the corporate governance codes of various countries. It is for the first time that the concept has been proposed to be introduced in Company Law in India. The Committee has however suggested that independent directors are required to be appointed only in respect of listed companies or the companies which have accepted public deposits.

The Committee has proposed that at least one-third of the Board should comprise of independent directors irrespective of whether the company has an executive or non-executive Chairman. This is though in contrast with Clause 49 of the listing agreement which provides for proportion of the Independent Directors on the basis of chairman being non-executive or non-executive.

No minimum qualification has been laid for an independent director. It has been specified that the appointment of independent directors should be made by the company from amongst persons, who in the opinion of the Board, are persons with integrity, possessing relevant expertise and experience and who satisfy the criteria for independence. This will indirectly ensure that only the persons possessing necessary knowledge, skills, and ethics are kept on the Boards of Companies.

The Committee has recommended that the expression 'Independent Director', shall mean a non-executive director of the company who:

- (a) apart from receiving director's remuneration, does not have, and none of his relatives or firms/companies controlled by him have, any material pecuniary relationship or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associate companies which may affect independence of the director.
- (b) is not, and none of his relatives is, related to promoters or persons occupying management positions at the board level or at one level below the board;
- (c) is not affiliated to any non-profit organization that receives significant funding from the company, its promoters, its directors, its senior management or its holding or subsidiary company;
- (d) has not been, and none of his relatives has

been, employee of the company in the immediately preceding year;

- (e) is not, and none of his relatives is, a partner or part of senior management (or has not been a partner or part of senior management) during the preceding one year, of any of the following:-
 - (i) the statutory audit firm or the internal audit firm that is associated with the company, its holding and subsidiary companies;
 - (ii) the legal firm(s) and consulting firm(s) that have a material association with the company, its holding and subsidiary companies;
- (f) is not, and none of his relatives is, a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director;
- (g) is not, and none of his relatives is, a substantial shareholder of the company i.e. owning two percent or more of voting power.

Explanation :

For the above purposes -

- (i) "Affiliate" should mean a promoter, director or employee of the non-profit organization.
- (ii) "Relative" should mean the husband, the wife, brother or sister or one immediate lineal ascendant and all lineal descendents of that individual whether by blood, marriage or adoption.
- (iii) "Senior management" should mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.
- (iv) "Significant Funding" – Should mean 25% or more of funding of the Non Profit Organization.
- (i) "Associate Company" – Associate shall mean a company which is an "associate" as defined in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements", issued by the Institute of Chartered Accountants of India.

Key managerial personnel

The Committee has identified CEO /MD /CFO and Company Secretary as the Key Managerial Personnel for all companies, whose appointment and removal shall be by the Board of Directors of the company concerned.

Key Managerial Personnel should be in the whole-time employment of only one company at a time and both the managing director and the whole time directors should not be appointed for more than 5 years at a time. However, the present requirement of having managing director/whole time director in a public company with a paid up capital of Rs.5 crores may be revised to Rs.10 crores by appropriate amendment of the Rules.

Special exemptions may be provided for small companies, which may obtain such services, as may be considered mandatory under law, from qualified professionals in practice.

Directors and Officers (D&O) Insurance

The long felt need of the corporate sector in regard to extending insurance cover for the key man and key directors of companies has been addressed by the committee. It is recommended that insurance of key men and key directors and senior officers of companies may be taken by means of general insurance policies and the insurance premium paid by the company for such a policy need not be treated as perquisite or income in the hands of director concerned. However, if the wrongful act of the director or concerned officer is established, then the appropriate amount of premium attributable to such person shall be considered as perquisite or income for the purpose of remuneration.

Directors and officers (D&O) insurance as a means by which directors/officers of companies seek to mitigate potential personal liability, is very much prevalent in many developed economies of the world.

Rights and liabilities of independent and non-executive directors

Independent directors should have access to accurate, relevant and timely information in order to discharge their duties and responsibilities effectively with this objective in mind, the Expert Committee has recommended that Independent/non-executive directors should be able to call upon the Board for due diligence or obtaining of record for seeking professional opinion by the Board, right to inspect records of the company, review legal compliance reports prepared by

the company; and in case of disagreement, record their dissent in the minutes.

The Committee also went into the question of whether independent directors should be liable for all acts on the same footing as executive directors or should they be granted immunity from certain offences. It has recommended that a non-executive /independent director should be held liable only in respect of contravention of any provisions of the Act which had taken place with his knowledge and where he has not acted diligently, or where the contravention has been with his consent or connivance.

It is further recommended that if the independent director does not initiate any action upon knowledge of any wrong, such director should be held liable. This implies, if irregularities come to the knowledge of the directors and yet they do not act proactively and exercise due diligence to ensure that the interest of the company is duly protected, then they should be held responsible.

Knowledge should flow from the processes of the Board. Additionally, upon knowledge of any wrong, follow up action/dissent of such independent directors from the commission of the wrong should be recorded in the minutes of the Board meeting.

Freeing the Managerial Remuneration of limits

Managerial remuneration in India has so far been restricted to certain limits in the case of public companies and private companies which are subsidiaries of public companies, with the overall limit being 11% of the net profits of the company during the financial year.

Internationally, the laws of various countries including U.K., Australia, Canada and Singapore do not provide for any upper ceiling or minimum level of directors' remuneration. The UK Companies Act provides for necessary disclosures about 'emoluments and other benefits of directors and others' in the notes to accounts (for a company which is not quoted). In case of quoted companies, it provides for preparation of Directors' Remuneration Report, which must be duly signed. The auditors of the company must also audit this report. The Act also provides for laying the Directors' Remuneration Report before the company in general meeting, approval by the members, delivery to the registrar and other related matters.

The Australian and Singapore Companies Acts provide that members with certain majority/voting power may obtain information about directors' remuneration. The Acts also mandate for audit of the statement of managerial remuneration paid, sending it

to the entitled persons and the laying the same before the general meeting.

Moving in tune with the international practice, the Committee has recommended removal of all ceilings on payment of directors' remuneration. Shareholders of companies have been empowered to decide as to how to remunerate their directors. However, this process is to be transparent and based on principals that ensure fairness, reasonableness and accountability. It is important that there should be a clear relationship between responsibility and performance vis-à-vis remuneration, and that the policy underlying Directors' remuneration be articulated, disclosed and understood by investors/stakeholders. To ensure transparency, it is recommended that Directors' Remuneration Report should form part of the annual report of the company and should contain details of remuneration package of directors including company's policy on directors' remuneration, the performance graph of the company and the remuneration of directors vis-à-vis the performance of the company.

Another important feature of the recommendations relating to managerial remuneration is the removal of all government approvals. The Committee felt that in the current competitive environment, where Indian companies have to compete for specialized manpower globally, it may not be feasible or appropriate for the government to interfere. Instead of the restrictive regime based on 'government approvals', the 'shareholder approval', regime be adopted. Decision on how to remunerate directors should be left to the company. However, this should be transparent and based on principles that ensure fairness, reasonableness and accountability. The shareholders have been recommended to be empowered to decide the remuneration of non-executive directors including independent directors with no government interference. The criteria for remuneration/compensation of non-executive/independent directors should be based on their attendance and contribution and performance of the company. This may be in the form of sitting fees for Board and committee meetings attended physically or participated in electronically and/or profit related commissions.

Committees of the Board

While recognizing the need for discretion of the Board to manage and govern the company through collective responsibility, the Expert Committee has mandated the constitution of certain committees of Board for certain categories of companies, whose

recommendations would be available to the Board for taking final decisions. These Committees are Audit Committee, Remuneration Committee and Stakeholders Relationship Committee. Although the concept of Audit Committee was already there in the Companies Act, 1956 the mandatory requirement of other two committees in respect of certain companies is new. While the constitution of Audit Committee and Remuneration Committee has been recommended as must for all listed companies and companies accepting public deposits, the stakeholders relationship committee is suggested to be constituted in companies having combined shareholder/deposit holder/debenture holder base of 1000 or more. The main recommendations in respect of these committees are as below:

Audit Committee for Accounting and Financial matters

- Majority of directors to be independent, if appointment of independent directors is required.
- Independent Chairman.
- Atleast one member to have financial knowledge.
- Chairman to attend AGM and provide clarifications relating to Audit. If Chairman is unable to attend, he may authorise any other member of Audit Committee to do so.
- Recommendations of the Committee not accepted by the Board to be disclosed in Directors' Report with reasons for overruling.

Stakeholders Relationship Committee

- To be constituted in companies having combined shareholder/ deposit holder/ debenture holder base of 1000 or more.
- Main objective shall be to monitor redressal of investor grievances.
- Non-executive director to act as Chairman.

Remuneration Committee

- Compulsory constitution in Public listed companies and any company accepting deposits.
- To comprise of non-executive directors including atleast one independent director if appointment of independent directors is required. In such a case, Chairman also to be independent.
- Main objective shall be to determine the company's policy and remuneration packages

of MD/Executive directors/senior management.

- Chairman or at least one member of the committee should be present in General Meeting to answer shareholders' queries.

Recognition to joint venture/shareholders' agreements

Over the years, several Court judgments have been pronounced in India on validity of joint venture agreements vis-à-vis the provisions of the Act contained in sections 9, 111A, etc. It has been held that the provisions of Joint Venture/Shareholders' Agreement will bind the company only if such agreement is endorsed/incorporated in the articles of the company itself.

The Committee recognised the issues involved in validity of joint venture covenants vis-à-vis the provisions of the existing Act. It was noted that joint venture agreements have several clauses pertaining to voting rights, additional quorum requirements, arbitration provisions, pre-emption rights or restrictions on transfer of shares etc. The effect of this framework is that dispute resolution in respect of joint venture provisions becomes subject to contract law provisions and is subject to lengthy arbitration. Companies, however, prefer such aspects to be addressed more speedily through the corporate processes.

The Committee has, therefore, recommended that a transparent modality for providing recognition to agreements between joint venture partners for corporate action should be worked out in company law, keeping in view the concern that such arrangements should not become a window for circumventing the essential provisions of the law.

Tracking and Treasury Stocks

Tracking Shares - The Committee has recommended the introduction of 'Tracking Stocks', also known as 'targeted stocks'. Tracking Stocks as a financial vehicle that tracks the performance of a particular division or subsidiary. A tracking stock is a type of common stock that "tracks" or depends on the financial performance of a specific business unit or operating division of a company, rather than the operations of the company as a whole. As a result, if the said unit or division performs well, the value of the tracking stocks may increase, even if the company's performance as a whole is not up to mark or satisfactory. The opposite may also be true.

By issuing a tracking stock, the different segments or divisions of the company can be valued differently

by investors. When a parent company issues a tracking stock, all revenues and expenses of the applicable division are separated from the parent company's financial statements and bound to the tracking stock. Often this is done to separate financial statement of a high-growth division from the financial statements of the parent company which may contain huge losses. The parent company and its shareholders, however, still control operations of the subsidiary.

Tracking stock carries dividend rights tied to the performance of a targeted division without transferring ownership or control over divisional assets. In contrast to a spin-off or an equity carve-out, the parent retains full control, allowing it to enjoy any operating synergies, or economies of scale in administration or finance. Shareholders of tracking stocks have a financial interest only in that unit or division of the company. Unlike the common stock of the company itself, a tracking stock usually has limited or no voting rights. When a tracking stock is issued, the company can choose to sell it to the markets (i.e., via an initial public offering) or to distribute new shares to existing shareholders. Either way, the newly tracked business segment gets a longer lease, but can still run back to the parent company if times get tough.

Even though the tracking stock is targeted at a specific subunit, the business subunit is still responsible for all of the firm's debts and the assets can be transferred in or out of the subunit as the common board of directors think fit. The assets of the tracking stock portion of the business continue to be owned by the parent company and can be used against the corporation's liabilities. In addition the capital raised through the issuance of tracking stock is not restricted for use only by the tracked business segment.

A key advantage of tracking stock is that it offers divisional managers a degree of decision-making authority that might otherwise be unattainable, given top management's reluctance to dilute its control over the division's assets. The practical effect would be to enhance job satisfaction for divisional managers, thus reducing retention risk and also increasing the company's responsiveness to changing market conditions. Also, investors have more direct access to the specific businesses of the parent, which can be highly useful in the case of a diversified company.

Treasury Stocks - The Committee has also recommended introduction of treasury stocks as a measure for raising of funds at a low cost. Presently, section 77A of the Companies Act, 1956 provides for

buy-back of securities. Once bought back, the relevant securities are to be extinguished. Internationally, however, a company can, subject to certain restrictions, hold bought back shares itself under the name "Treasury Stock". In other words, Treasury Stocks are the shares which a company legitimately holds on its share register in its own name. The voting rights on these Treasury Stocks are suspended and company cannot exercise voting rights on such shares. No distribution of dividend (including dividend during winding up) can be made to such stock.

The Committee felt that a number of preparatory actions were required before the concepts of Tracking Stocks and Treasury Stocks could be introduced, such as the regulations to be framed by capital market regulator, development of appropriate, specific accounting standards etc. It therefore recommended that while an enabling provision for Tracking / Treasury Stocks could be incorporated in the new Law, actual introduction of Tracking and Treasury Stocks in the Indian Capital Markets be made only when the necessary framework is ready.

Perpetual Preference Shares

As per the existing provisions, preference shares can be issued for a maximum period of 20 years. As many companies may like to raise capital of a quasi equity and permanent nature on account of long gestation project capital requirements, the Committee felt that the concept of perpetual preference shares or preference shares of higher tenure be permitted in the new Law. The Committee recommended that companies should be permitted to issue perpetual/ longer duration preference shares and that returns from such shares may be linked to market benchmark or reset periodically. In case the subscriber of perpetual preference shares wants to redeem his shares prematurely, necessary enabling provisions to redeem the shares by the company up to a certain percentage of preference shares on an annual basis may be provided. This may be done through "call/ put option mechanism". The Committee also felt that flexibility should be given to the companies to revise the tenure of already issued preferential shares by obtaining prescribed approval of shareholders for variation of rights.

Single Window Clearance for Mergers

The Committee recognised the fact that the Indian merger law, as it exists today, is cumbersome and time consuming and rightly emphasized on the need for speedier disposal of mergers and acquisitions (M&As) proposals. Mergers and acquisitions today are a widely used multipurpose business tool that can bring long-

term benefits in the context of increasing competitiveness in the market. The Committee addressed on formulation of a corporate insolvency legislation which would enable to carry out M&As with "digital speed" and made several recommendations in this regard. One of the recommendation is a single window clearance for the purpose. The law should provide for a single forum which would approve the schemes of mergers and acquisitions in an effective time bound manner. The concept of 'deemed approval' should be provided for in cases where the regulators do not intimate/inform their comments within a specified time period to the Court/Tribunal before which the scheme of merger/amalgamation is submitted for approval.

Empowering the National Company Law Tribunal to grant clearance for all aspects of the merger/ amalgamation would obviate the need to approach different forums for clearances required for the merger/ amalgamation and hasten the process. This would address the problem that has ailed Indian businesses for long.

Contractual Mergers

The Committee was of the view that contractual mergers may be given statutory recognition in the Company Law in India as is the practice in many other countries as a restructuring tool to hasten the process of mergers and acquisitions. Such mergers and acquisitions are in the contract form (i.e. without the intervention of the court) and are made subject to subsequent approval of shareholders by simple majority.

The recognition of such contractual mergers would eliminate obstructions to mergers and acquisitions, give ex-post facto protection and the ability to rectify them.

Committee felt that steps should be taken to validate contractual mergers because court-oriented process many times leads to delays. Even as judicial process is important to take care of the interest of minority shareholders, many times it is used as a tool to abuse and derail the process. In fact, "Some very well-meaning mergers and acquisitions are taken to court by motivated shareholders with vested interests to derail the process".

Time-bound proceedings for restructuring and liquidation

The Committee recognised the business need for efficient and speedy procedures for exit as much as for start up. The Committee noted that a recent survey by World Bank (Doing business in 2005 – India Regional Profile) has pointed out that it takes an average 10 years

to wind up/liquidate a company in India as compared to 1 to 6 years in other countries. Such lengthy time-frames are detrimental to the interest of all stakeholders. The process should be time-bound, aimed at maximizing the chances of preserving value for the stakeholders as well as the economy as a whole.

The Committee has recommended that a single independent forum should be created for accelerating the liquidation process and a definite and predictable time frame should be provided for. The existing time frame in India is too long and keeps precious assets locked in proceedings for many years, destroying their value in the process. In this protracted and never-ending process, the assets not only lose value but even disappear and vanish. On an average, a time frame of two years should be feasible for the liquidation process to be completed. A period of one year should be adequate from commencement of the process till sanction of a plan. There should also be a definite time period within which proceedings may commence from the date of filing of the application for rehabilitation.

The legislation should limit the possibility of appeals at every stage so that the process is not delayed through frivolous appeals or stalling tactics. A fixed time period should be provided for at each stage of rehabilitation and liquidation process. Extension at every stage should be rare and allowed only in exceptional circumstances and in any case without effecting the outer time-limit provided for the process.

On an average a time frame of 2 years should be feasible for the liquidation process to be completed.

Insolvency Practitioners

Keeping in view the important role of professionals and experts in the insolvency process, the Committee has recommended the recognition of the concept of 'Insolvency Practitioners'. Currently, the law does not support effective participation of professionals and experts in the insolvency process. Law should encourage and recognize the concept of Insolvency Practitioners (Administrators, Liquidators, Turnaround Specialists, Valuers etc.) and disciplines of chartered accountancy, company secretaryship, cost and works accountancy, law etc. can act as feeder streams, providing high quality professionals for this new activity. Greater responsibility and authority should be given to Insolvency Practitioners under the supervision of the Tribunal to maximize resource use and application of skills.

The insolvency fund

The Committee proposed that the provisions relating to rehabilitation cess should be replaced by the concept of 'Insolvency Fund' with optional contributions by companies. The Government may make grants for the fund and provide incentives to encourage contributions by companies to the fund. Companies which make contributions to the fund should be entitled to certain drawing rights in the event of insolvency. Administration of the fund should be by an independent administrator. Insolvency fund should not be linked/credited to Consolidated Fund of India.

International Considerations

Key international initiatives like United Nations Commission on International Trade Law (UNCITRAL) legislative Guide on Insolvency, World Bank Principles for Efficient Insolvency and Creditors Right Systems International projects were examined by the Expert Committee to bring the provisions in tune with international developments.

A strong need for a suitable framework for Cross Border Insolvency which provides for rules of jurisdiction, recognitions of foreign judgments, co-operation and assistance among Courts in different countries and choice of law is recommended by the Committee. It is also suggested that the Government may consider adoption of UNCITRAL Model Law on Cross Border Insolvency with suitable modifications at an appropriate time.

End Note

The process of reforms in Company Law is indeed a herculean task. And this task is being undertaken globally to enact comprehensive, simple and effective company law which not only provides a flexible framework for corporate entities to compete globally, but also imposes strict corporate responsibility thereby ensuring protection of all stakeholders. Corporate reporting of social and environmental aspects too is being recognised as an essential ingredient of new Company Law.

The recommendations contained in UK White Paper 2005 and Dr. J.J. Irani Committee Report are visionary and need to be implemented at the earliest by the respective countries, to provide a forward looking legal framework for corporates and all concerned stakeholders.