CONTENTS

THE STATE OF CORPORATE GOVERNANCE

EXPERIENCE FROM COUNTRY ASSESSMENTS

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INTRODUCTION

In the wake of the international financial crisis of the 1990s, the international community embarked on a range of initiatives to strengthen the international financial architecture. The objective of these initiatives is crisis prevention, mitigation and resolution. The agenda focuses on weaknesses in the international financial system that potentially contribute to the propensity for and magnitude of global instability, hence requiring collective action at the international level.

There is widespread recognition that global financial stability rests on robust national systems and hence requires enhanced measures at the country level. In a world of integrated capital markets, financial crises in individual countries can imperil international financial stability. This provides a basic "public goods" rationale for minimum standards which benefit international and individual national systems.

The Financial Stability Forum, the G7, the G20 and the G22[1] have emphasized, in particular, the role of minimum standards and codes in strengthening the international financial architecture. At the international level, standards enhance transparency. They identify weaknesses that may contribute to economic and financial vulnerability. They foster market efficiency and discipline. At the national level, standards provide a benchmark to identify vulnerabilities and guide policy reform. To best serve these two objectives, the scope and application of such standards need to be assessed in the context of a country's overall development strategy and tailored to individual country circumstances. The IMF, the World Bank and other international financial institutions are undertaking the assessment of systemically important countries of the observance of 11 core standards relevant to private and financial sector development and macroeconomic stability[2] .

In this context, the Bretton Woods institutions have initiated the joint initiative on *"Reports on the Observance of Standards and Codes"* ("ROSCs"), which covers a set of eleven internationally recognized core standards relevant to economic stability and private and financial sector development. The individual standard assessments are collected as "modules" in country binders constituting the aforementioned "ROSCs". Under this modular approach, the IMF takes the lead in preparing assessments in the areas of data dissemination and fiscal transparency. Modules for the financial sector (monetary and financial policy transparency, banking supervision, securities market regulation, payment systems, deposit insurance) are mostly derived from the *Financial Sector Assessment Program* ("FSAP"). The World Bank takes the lead in three areas: (i) corporate governance, (ii) accounting and auditing, and (iii) insolvency regimes and creditor rights.

Box I : **Chronology of the ROSC initiative**

July 1998: IMF Executive Board indicates that the official sector should play a larger role in strengthening incentives to implement standards, including through monitoring the extent to which members observe standards in areas within the Fund's direct operational focus.

October 1998: G-22 Taskforce Recommendations - the G-22 working group recommends that the IMF, in the context of its Article IV surveillance consultations, should consider preparing a report - a Transparency Report - that summarizes the degree to which an economy meets internationally recognized disclosure standards across a wide range of areas.

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October 1998: G-7 endorses G-22 recommendation and calls on the IMF to "monitor in close cooperation with the standards-setting bodies the implementation of... codes and standards as part of its regular surveillance under Article IV".

1999/2000: IMF Executive Board decides to undertake reports on international financial architecture issues to be called "Transparency Reports." The World Bank joins the IMF in this exercise which is expanded to include other assessments and is now named the Reports on the Observance of Standards and Codes (ROSCs).

ROSC and FSAP assessments

The ROSC and the FSAP programs are tools to assess financial sector vulnerability and development needs. They provide input to the Fund for its surveillance activities and are useful instruments to support the policy dialogue of International Financial Institutions, policy makers and the private sector. They can contribute to the design of loans, assist in the preparation of key policy documents and provide benchmarks for the designs and monitoring of technical assistance and capacity building programs.

Countries volunteer for a ROSC or FSAP program. They can choose either or both of the programs. FSAP contains a section that remains confidential between the Fund/Bank and the assessed country. In contrast, ROSC assessments have a vocation to become public documents. The IMF and the World Bank have set up special purpose websites to disseminate ROSC assessments into the public arena. Publication is voluntary. Countries can either refuse the publication of an assessment; authorize its publication while exercising a "right of reply," which gives them an opportunity to express their disagreement with the opinions of the IMF/World Bank; or authorize its publication as it stands. To remain useful, assessments of progress in implementing standards must be updated periodically.

The World Bank Corporate Governance Assessments

The first step in developing a methodology to assess the corporate governance system of a given country was the identification of a standard. In contrast to the World Bank team in charge of the Insolvency and Creditor Rights ROSC, which had to develop a standard, the corporate governance team of the Private Sector Advisory Services Department (PSAS) could use the OECD Principles as the benchmark. The OECD Principles were agreed upon by a large number of countries (29) of varied legal, economic and cultural traditions and after extensive consultation with the World Bank, the IMF, the Bank of International Settlements, and representatives of the business community from Japan, Germany, France, UK and the US, as well as international investors, trade unions and other interested parties. Consultations also took place with a number of emerging market governnents. As such, they represent the minimum standard that countries with different traditions could agree upon, without being unduly prescriptive. In particular, they are equally applicable to countries with a civil and common law tradition, different levels of ownership concentration, and models of board representation.

The benchmark: the OECD Principles of corporate governance

The OECD Principles of corporate governance are general guidelines for regulating the entry, on-going obligations, and exit of companies to and from equities markets. According to the OECD Task Force that drafted them, the Principles were devised with four fundamnental concepts in mind: responsibility, accountability, fairness and transparency. The Principles allow for diversity of rules and regulations.

The OECD Principles are primarily concerned with listed companies. They are organized into five sections, (1) the rights of shareholders, (2) the equitable treatment of shareholders, (3) the role of stakeholders in corporate governance, (4) disclosure and transparency and (5) the responsibilities of the board.

The IOSCO Principles deal with the regulators of financial markets, self-regulating organizations (SROs), enforcement, cooperation in regulation, collective investment schemes (investment funds), market intermediaries, secondary securities markets and issuers. The OECD Principles complement the IOSCO Principles of financial market regulation by focusing in more detail on disclosure and transparency of issuers and equitable treatment.

The OECD Principles state that board members are accountable to shareholders and to the company.[3] Accountability to shareholders means equal treatment of majority and minority shareholders. Accountability to the company means that directors must ensure that the company complies with existing laws and regulations, such as tax, labor, health and safety laws, equal opportunity, environmental legislation, and competition law.

The Principles stress that stakeholders, in particular creditors, employees and consumers, play an integral part in shaping the decisions of a company. Principle III states that "...the corporate governance framework should encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises". The full social responsibility debate goes beyond the scope of this paper.

In particular, corporate governance deals with the checks and balances that need to be put in place to deal with the problem resulting from the separation of management and ownership in corporations. Board members and management need to have enough independence to manage the company's affairs as they best see fit without undue interference from outsiders, as long as they do it prudently, with diligence and care, and in the interests of shareholders. Checks and balances are necessary to ensure accountability, since people are likely to manage their own affairs more carefully than those of others.

The OECD Principles are non-binding. They provide a framework for dialogue on country experience and identification of policy reform "without prejudice to the prerogative of each nation to find its own path to better corporate governance."[4] The aim is a common framework in which good corporate governance practices can develop, in consistency with national regulations and traditions.[5]

A process of consultation is currently being put in place to assess the effectiveness of the Principles as a policy tool and core standard. In line with the decisions taken at the 1999 OECD Council meeting at Ministerial level, preparatory work for an assessment of the OECD Principles will begin in 2002 with the intention of undertaking a full review in 2005. The first stage will consist of analytical reports on corporate governance complemented by research papers on current trends based on a questionnaire circulated among members countries. Since their publication, several new codes have been released, including the Combined Code in the UK and the King II Report in South Africa, which in some respects, are more prescriptive than the OECD Principles.

The Regional Roundtables on Corporate Governance, a joint OECD/World Bank initiative, follow the structure of the five chapters of the OECD Principles. The Roundtables were launched by the Memorandum of Understanding signed by President J. Wolfensohn and Secretary General D. Johnston in June 1999 to disseminate best practice in corporate governance and increase the ownership of reform in developing countries and transition economies. In addition, the World Bank and the OECD set up the Global Corporate Governance Forum, a multi-donor trust fund, to (a) disseminate best practice and raise awareness of the need for reform; (b) foster academic research; and (c) provide a source of finance for implementation of reform and capacity building.

Process and format

The Template

To assess countries, the World Bank has produced a questionnaire in the form of a template (the "Template"). It is structured along the five chapters of the OECD Principles. The objective of having the Template is to facilitate the gathering of information necessary to formulate a diagnostic of the institutional framework underlying corporate governance, as well as prevailing practices and enforcement. For each OECD Principle, a set of questions have been prepared to assess the compliance of the country under assessment. Questions have been drafted so that they can be answered by "yes" or "no" as often as possible, to allow benchmarking.

The Template includes a section on the ownership structure of the assessed country, since this is an important determinant of corporate governance practices. It endeavors to identify pyramid structures, cross shareholdings, and business groups and gathers information on the divergence between cash flow rights and voting rights. While the OECD Principles are mainly concerned with the rights of shareholders and stakeholders, disclosure and the responsibilities of insiders, the template also addresses the issue of institutional capacity.

A first Template was produced at the beginning of year 2000 and revised in the same year. Consultation took place for the preparation of the second generation Template.[6] In its current form, the Template is applicable mainly to non-financial enterprises. A third generation Template is currently in progress. The objective of this exercise is to focus on the assessment of banks and non-bank financial institutions, such as insurance companies and pension funds. The third generation Template will also include some more detailed questions on the governance of securities regulators in a manner complementary to the International Organization of Securities Commissions (IOSCO) principles.

The assessment

There are two ways of conducting corporate governance country assessments - as an "external" or as an "assisted" self assessment. While the World Bank is responsible for researching and drafting the assessment under the first approach and the country's policy makers validate the findings, under an "assisted" self assessment the country is involved in all stages of the process. This approach works well when the authorities of the assessed country are committed to reform. In the "assisted" self assessment, the ability of the local authorities to provide complete and accurate information may be impaired by political considerations. For example, it may be difficult for a regulatory agency to acknowledge that the existing legislation is not properly enforced. However, if these constraints are not there, the "assisted" self assessment increases the degree of ownership of domestic policy makers and helps develop capacity.

The format of the reports complies with the operational guidelines for ROSC reports issued by the World Bank and the IMF. The content has evolved over time. It started with a 15-page narrative describing corporate governance practices of the assessed country, plus a matrix benchmarking the adherence to each OECD Principle. In a second phase, policy recommendations were added. The latest format attempts to differentiate between compliance of the legal and regulatory framework and actual practices of market participants, and includes a chapter on institutional strengthening. It also reconciles the corporate governance modules for FSAPs and ROSCs.

The format of the assessments allows for systematic benchmarking across countries and regions. It is divided into four parts: (i) executive summary, (ii) capital market overview and institutional framework, (iii) principle by principle review including policy recommendations and, (iv) institutional strengthening.

Each OECD Principle is evaluated based on quantitative and qualitative standards. "Observed" means that all essential criteria are met. "Largely observed" means that only minor shortcomings are observed, which do not raise any questions about the authorities' ability and intent to achieve full observance within a reasonable period of time. "Partially observed" means that while the legal and regulatory framework may be fully compliant with the OECD Principle, practices and enforcement diverge. "Materially not observed" means that, despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance. "Not observed" means that no substantive progress toward observance has been achieved.

The assessment is most useful when the country under assessment is committed to a reform agenda and agrees to the publication of the report through the World Bank ROSC website http://www.worldbank.orn/ifa/rosc ca.html. The assessments are complementary to private sector rating activities. The World Bank assessments focus on country analysis, while some rating agencies have started to focus on companies. Standard & Poor's and Moody's have begun rating companies in emerging markets. Other similar exercises are carried out by specialized firms such as Pensions Investment Research Consultants in the United Kingdom or Deminor in Belgium and France. New rating companies for corporate governance have emerged in Russia and Korea.

Policy recommendations

Policy recommendations are suggestions for countries that want to compete for international portfolio capital. A "one size fits all" solution is not advocated. Examples are provided of how other countries have overcome similar problems. They provide choice for issuers, countries and investors alike. In the global market, both countries and issuers compete for capital. The driving principle is to encourage choice and let market forces pick the winners.

Choice enables reputational costs and benefits to play their role. If there is no choice, the benefit of complying with international best practice is difficult to capture. If there is choice, recipients of capital can signal to the market that they are different. This approach was recently followed by Brazil, as discussed in Box II. Over time, it is expected that governance regimes that are less transparent and provide less protection to minority investors, will find it more difficult and more expensive to attract capital.

Box II : **The Brazilian Novo Mercado**

In 2001, BOVESPA, the Sao Paulo stock exchange, launched a new market segment, the Novo Mercado, which aspires to international standards of corporate governance. The Brazilian approach is innovative. Traditionally, new segments have been introduced by stock exchanges to encourage small and medium size enterprises to become listed. Listing rules for the new segments have usually been watered down versions of listing rules on the main board. Not so in Brazil. The companies listed on the Novo Mercado will be prohibited from issuing non voting shares whilst companies on the main board can do so. They will have to abide by US or international accounting standards and their free float[7] will be at least 25 percent. An arbitration panel has been created to settle shareholder disputes. As a result, some investment banks, such as Merrill Lynch, have put the Novo Mercado at the top of their rankings for minority shareholders rights and significantly above the main Brazilian board ranking.

The rationale for the creation of the Novo Mercado is to allow companies that want to abide by international best practice to differentiate themselves from the Brazilian main board. It is also expected that their adherence to the Novo Mercado listing rules will allow companies to attract quality domestic and international investors and ultimately lower their cost of capital. For example, Brazilian pension funds will be allowed to invest a higher proportion of their assets in companies listed on the Novo Mercado. Likewise, the Banco National de Desenvolvimento Econ6mico e Social (BNDES), the state-owned development bank, is offering more attractive lending terms to companies that list there.

The policy recommendations offer alternatives about how to comply with the OECD Principles through the effective enforcement of the existing legal and regulatory framework. Sometimes the recommendations include the modification of existing laws or rules or the adoption of new ones. The recommendations also focus on how companies can improve their internal governance structures. The endorsement and ownership of the reform program by the private sector is essential for corporate governance reform to be successful. Therefore, policy recommendations may include measures to encourage the development of private sector associations such as institutes of directors, non-for-profit shareholder associations or other business associations, which operate in parallel with existing public institutions and provide private solutions to information dissemination.

The policy recommendations should be construed as a set of interdependent measures that need to be implemented simultaneously to be effective. Take, for example, the concept of equitable treatment of shareholders. One obvious way of enhancing the protection of minority shareholders is to introduce the option of "cumulative voting" for the election of board members, so that minority shareholders have a chance of being represented on the board. However, this measure alone may not prove effective. The introduction of cumulative voting in the Philippines did not result in greater representation of minority shareholders on boards of directors, because in most instances, the number of minority shareholders present and voting at the Annual General Meeting was insufficient to win enough votes on one candidate. Complementary measures, such as proxy voting, voting by mail and the introduction of the concept of independent directors, are necessary to enhance equitable treatment. Each countiy's specific circumstances, priorities, and level of development should drive the sequencing of reform.

Key findings

For ease of reference, the discussion regarding key findings has been divided to correspond with the five sections of the OECD Principles. Each section highlights deviations from the OECD Principles or describes compliance. One major key finding is that the legal and regulatory frameworks of the assessed countries are largely compliant with the OECD Principles. However, practices are not. The difficulty or the assessments is to reflect the discrepancies between the letter of the law and compliance.

Table 1 sets out the consolidated matrix for 12 countries.[8] The consolidated matrix is the merger of two matrices. The first one was used to benchmark the first generation of assessments. It has three entries: "Yes," "No," and "Incomplete."[9] The second generation matrix was used until December 2001. It has four entries: "Observed," "Largely Observed," "Materially Not Observed" and "Not Observed."[10] Therefore, the consolidated matrix has four categories: "Observed/Yes," "Partially Observed," "Not Observed/No" and "Not available." The column "Partially Observed" includes the scores "Largely Observed," and "Materially Not Observed," as well as the score " Incomplete" from the first assessments. In addition, it should be noted that the first generation matrix did not cover the stakeholders section and some other minor issues, as indicated by the entry "Not available."

Table 1 : **Summary Matrix**

OECD Principles	*Observed/ Yes*	*Partially Not observed*	*Not observed/ No*	*Not Avail-able*
Section I : The Rights of Shareholders				
A. Basic shareholders rights:				
(i) Ownership registration	*****	*******		
(ii) Share transfer	******	******		
(iii) Access to information	***	*********		
(iv) Participation and voting at AGM	******	******		
(v) Election of board	******	******		
(vi) Share in the profit	*******	*****		
B. The right to participate in decisions on fundamental corporate changes				
(i) Amendments to the statutes	*******	*****		
(ii) Authorization of additional shares	*****	******	*	
(iii) Extraordinary transactions (resulting in sale of the company)	****	********		
C. The right to be adequately informed about, participate and vote in general shareholder meetings (AGM) :				
(i) Sufficient and timely information about AGM	*******	****		
(ii) Opportunity to ask question and place items on agenda	**	*******	*	**
(iii) Vote in person or in absentia	*	***********		
D. Disclosure of capital structures and arrangements enabling control disproportionate to equity ownership	****	********		
E. Efficient and transparent functioning of market for corporate control.				
(i) Clearly articulated and disclosed rules and procedures, transparent prices and fair conditions	**	********	**	
(ii) No use of anti-takeover devices to shield management from accountability	**	*****	*	****
F. Requirement to weigh costs/benefits of exercising voting rights		**	*******	***

OECD Principles	*Observed/ Yes*	*Partially Not observed*	*Not observed/ No*	*Not Avail-able*
Section II : Equitable Treatment of Shareholders				
A. *Equal treatment of shareholders within same class*				
(i) Same voting rights for shareholders within each class. Ability to obtain information about voting rights attached to all classes before share acquisition. Changes in voting rights subject to shareholder vote.	********	****		
(ii) Vote by custodians or nominees in agreement with beneficial owner.	****	**	***	***
(iii) AGM processes and procedures allow for equitable treatment.				
Avoidance of undue difficulties and expenses in relation to **votmng.**				
B. *Prohibition of insider-trading and self-dealing*	*****	*******		
C. *Disclosure by directors and managers of material interests in transactions or matters affecting the company.*	**	**********		
Section III : Role of Stakeholders in Corporate Governance				
A. *Respect of legal stakeholder rights*	*	******		*****
B. *Redress for violation of rights*	*	******		*****
C. *Performance-enhancing mechanisms for stakeholder participation*	*	******		*****
D. *Access to relevant information*		*******		*****
Section IV : Disclosure and Transparency				
A. *Disclosure of material information*				
(i) Financial and operating results	*******	*****		
(ii) Company objectives	*	******	*	
(iii) Major share ownership and voting rights	******	******		
(iv) Board members, key executives and their remuneration	**	**********		
(v) Material foreseeable risk factors		*****	*****	**
(vi) Material issues regarding employees and other stakeholders		*****	***	****
(vii) Governance structures and policies	*	***	******	**
B. *Preparation of information, audit, and disclosure in accordance with high standards of accounting, disclosure, and audit*		****** ******		

OECD Principles	*Observed/ Yes*	*Partially Not observed*	*Not observed/ No*	*Not Avail- able*
C. *Annual audit by independent auditor*	**	**********		
D. *Channelsfor disseminating information allow for fair, timely, and cost-efficient access to information by users*	*****	*******		
Section V : Responsibilities of the Board				
A. *Act on an informed basis, in goodfaith, with due diligence and care, in the best interest of the company and shareholders*	**	**********		
B. *Fair treatment of each class of shareholders*	****	*****		****
C. *Compliance with law and taking into account stakeholders' interests*	***	*****		****
D. *Keyfunctions.*				
(i) Corporate strategy, risk policy, budgets, business plans, performance objectives, implementation and performance surveillance, major capital expenditures, acquisitions, divestitures		************		
(ii) Selection, monitoring, replacement of key management	**	*********		*
(iii) Key executive and board remuneration, board nomination	*	**********		*
(iv) Monitoring of conflict of interest of management, board members, and shareholders, including misuse of corporate assets and abuse in related party transactions.		*********	**	*
(v) Ensuring integrity of accounting and financial reporting systems, including independent audit, systems of control, compliance with law	*	**********	*	
(vi) Monitoring governance practices and making necessary changes	*	****	***	****
(vii) Overseeing disclosure and communi- cation	***	******	*	**
E. *Objective judgement on corporate affairs:*				
(i) Assignment of non-executive board members to tasks of potential conflict of interest (e.g. financial reporting, remuneration)	*	********	**	*
(ii) Devote sufficient time to their responsi- bilities	*	*******	*	***
F. *Access to accurate, relevant, and timely information*	***	*****	*	***

Section I : The rights of shareholders

Registration of shares has historically been the responsibility of the company. This power vested in management created difficulties arising from agency problems between managers and shareholders. In some countries, e.g. Croatia, Morocco, and Turkey, companies can object to or block share transfer and ownership registration. In India, the transfer of physical shares often results in delays and increases the likelihood of fraud or theft. These are deviations from the right of shareholders to secure ownership registration. Most of the countries surveyed have created central depositories that speed up the process of share transfer and registration and make them more secure. This removes the power to register shares from insiders.

While voting is a basic right of ordinary shareholders in most countries, owners of bearer shares do not have the right to vote in Egypt. In Brazil, the majority of investors own shares without voting rights (the so-called PN shares[11]). On the other hand, shareholders who have paid up only 50 or less percent of the share issue price have full voting rights in Croatia, Morocco and Egypt.

In all assessed countries, fundamental corporate decisions are made with a supermajority of shares voting and present. Shareholders can delegate the authority to issue new shares to the board. This does not contradict the OECD Principles. However, the question arises whether there should be a ceiling on the amount of shares and time frame within which they can be issued. In Croatia, companies may receive authorization from shareholders (if approved by 75 percent of the shares at the meeting) to issue up to 50 percent of share capital for a period of up to five years. The law also allows the management board to increase the company's share capital by converting company bonds into new shares up to the amount of the share capital of the company. Finally, the law permits company statutes to waive existing shareholders' pre-emptive rights on new share issues.

As recommended under the OECD Principles, shareholders owning between five and ten percent of capital can convene a shareholder meeting or add resolutions to the agenda in most countries surveyed (Romania and South Africa are the exception). In none of the assessed countries is the revised agenda circulated at the expense of the company. On voting procedures and the right to vote in absentia, all countries allow physical proxies. In Latvia, efforts to introduce electronic voting are underway. India recently introduced a non-mandatory requirement to use postal voting for certain important resolutions such as mergers and acquisitions and buy-back of shares. Malaysia also permits voting by mail.

Disclosure of capital structures is generally in line with the OECD Principles in the sense that, if a shareholder wants to know the first level capital structure of a listed company, there is a way to gather this information. Typically, the annual report, the stock exchange, the registrar or the annual general meeting (AGM) will provide it. *Stricto sensu,* therefore, the country is in compliance with the OECD Principle. However, the information is often hard to get; and if there are pyramid structures and cross shareholdings as for exarnple in Egypt and Morocco, or nominee owners, it is difficult to identify the ultimate controlling shareholder. In Romania, investors tend to protect themselves behind off-shore vehicles incorporated in Cyprus, where there are no requirements to disclose ownership. Consolidation is often not mandatory under national accounting rules. It is therefore impossible to detect pyramid structures and indirect cross shareholdings. Georgia is noticeable amongst the assessed countries for having introduced a requirement to disclose ultimate beneficial ownership beyond the five percent threshold.

The assessed countries are characterized by concentrated ownership structures. Ownership concentration implies that the corporate takeovers only take place in a friendly environment. Malaysia, Poland and India have takeover codes and mandatory tender offer rules. While a mandatory tender offer exists in Egypt, it does not extend to all shares. It is not common for corporate law to request a shareholder vote on the sale of substantial assets.[12]

The OECD Principle which states that shareholders should consider the costs and benefits of exercising their voting rights is based on the premise that positive financial returns can be obtained by exercising voting rights. This principle is not observed in any country surveyed, although Malaysia is taking steps in this direction. There is little shareholder culture, and the costs of exercising voting rights and the danger of upsetting incumbent management are deemed greater than the benefits in the short term. Also, pension funds are often not well developed, if they exist at all. However, it can be argued that this OECD Principle is even more important in developing and transition economies than in industrialized countries because in the latter investors can "vote with their feet", i.e. sell their holdings if they are dissatisfied with the governance of their portfolio companies, whereas in the former investors cannot do so easily without moving the market. All countries surveyed require that shares be blocked from trading a certain time before the annual general meeting (AGM) for votes to count, except for Romania which has introduced a "date of record". The introduction of a date of record for proof of ownership is one way to create incentives for institutional investors to vote, because it does not inhibit them from selling their shares after the date of record.

Section II : The equitable treatment of shareholders

The concept of protection of minority shareholders is not well developed in the countries surveyed as shown by the case discussed in Box IV below. Most countries comply with the requirement that shareholders should have timely and sufficient information about the annual general meeting, except for Georgia, Brazil and the Philippines where the notice periods are too short or are not well circulated and important agenda items can be omitted. In India, there are companies which opt to hold the annual general meeting in remote places, which makes it difficult and sometimes expensive for minority shareholders to attend. With regards to the exercise of voting rights by custodians or nominees in agreement with beneficial owners, it is impossible to track beneficial owners in Croatia, Georgia and the Philippines, while in Egypt the concept is now being introduced in the new Depository Law.

Despite the fact that insider trading and self-dealing are a criminal offense in all assessed countries, monitoring and detection remain a problem across the board. The securities regulators are generally not equipped to carry out their surveillance activities efficiently and depend on an often overburdened, weak or slow court system for enforcement. In addition, commercial tribunals do not exist in all countries.

Box III : **Difficulties in enforcing equitable treatment of shareholders**

A recent case illustrating the lack of equitable treatment in the market for corporate control was the acquisition of the Moroccan bank Banque Morocaine de I' Afrique Occidentale (BMAO) by a listed state-owned bank called Banque Nationale pour le Developpement Economique (BNDE) in 2000. BNDE commissioned one of the big five consulting firms to do the valuation. BMAO's minority shareholders representing ten percent of capital objected to the buyout price and requested a second valuation. A press campaign was initiated against the dissenting shareholders, arguing the law should not allow just any shareholder to bring a transaction to a standstill. The minority stakeholders lost their case.

This example illustrates the conflicts that prevail in countries where the rights of minority shareholders are not well understood and where a shareholder culture does not exist. BMAO was widely known to have a balance sheet with serious problems. In consequence, the valuation might well have been favorable to minority shareholders. Nevertheless, this is not the point. The minority shareholders were not able to go through with their motion of a second valuation. It was not deemed acceptable that minority shareholders would question a decision of management/controlling shareholders.

Disclosure by directors and managers of material interests in transactions or matters affecting the company is less than fully observed in most countries. The regulatory framework usually includes rules and regulations for disclosing and monitoring related party transactions and self-dealing. However, disclosure is not always mandatory, or there are no clear rules. In Morocco, related party transactions must only be disclosed if they take place under "special conditions." There is a general concern that existing provisions are not consistently adhered to and cannot be enforced in environments often characterized by pyramid structures, cross shareholdings and a weak judicial system.

Section III : The role of stakeholders

Stakeholders are generally defined as all those who have a material relationship with the company that is not based on share ownership. These includes employees, creditors, customers, suppliers, local communities and even society at large.

The OECD Principles state that the corporate governance framework should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. Stakeholders are protected by contracts, competitive markets and through laws and regulation. Regulation is necessary, because markets are imperfect. They sometimes generate negative externalities, or fail to protect certain stakeholders of the firm adequately. For example, since contract law has been found to be insufficient to govern all aspects of the long-term relationship between workers and the firm, the law of labor contracting, pension law, health and safety law and anti-discrimination law have been developed. Similarly, since the firm has an incentive to embark on activities that may destroy the environment of the communities located near the enterprise, environmental legislation and the law of nuisance and mass tort have been developed. Likewise, to protect consumers, product safety regulation, warranty law, tort law governing product liability, antitrust law, and mandatory disclosure of product content have been introduced.

Other rules and regulations include tax laws, bankruptcy law, corporate law and securities law. These laws are necessary to protect the interests of states, creditors and minority investors. For example, corporate law and bankruptcy law protect creditors from shareholders that indulge in abusive behaviors. Corporate law includes rules for "piercing the corporate veil," whereby creditors can hold shareholders liable beyond their limited liability when they have interfered with the running of the company in a manner that results in the company's being unable to service its debt obligations. Similarly, creditors can block dividend distribution in the presence of inadequate capital.

Company boards must also ensure that adequate mechanisms are in place to provide familiarity and compliance with legislation related to the rights of stakeholders. Mechanisms are needed so that the firm and its officers understand and observe the legal rights of stakeholders. Companies need to consult and communicate with employees and other stakeholders.

While such a legal and regulatory framework may be in place in developing countries and transition economies, the lack of enforcement capability of the judiciary may result in insufficient protection of stakeholders. Consequently, additional protections - such as board representation- may be warranted. In addition, some companies have found it advantageous to take voluntary measures to foster good stakeholder relations.

Worldwide, stakeholders are seldom represented on the board. Exceptions are e.g. Germany, China, the Czech Republic, Austria, Egypt, Denmark, Norway and Sweden where employees have the right to elect representatives to the (supervisory) board. In transition economies, such as Poland, it is customary for creditors to sit on the board of the company they lend to. Their interest is thus protected by board representation.

The debate in transition economies on the role of stakeholders in corporate governance has been developing in a different context from the one prevailing in OECD economies and developing countries. The main concern of transition has been to move away from the model of the enterprise as a social unit towards an enterprise that is a profit-making entity based on clear property rights and capable of attracting capital.

In Romania, unions have a voice in corporate restructurings and collective bargaining. Employees have a right to be informed by companies and to conduct negotiations through employee representatives in cases of increase in charter capital, reorganization, liquidation and other key decisions that might impact on the deterioration of work conditions. Trade unions can also initiate such consultations. However, consultation and other labor rights contained in labor laws are not always observed in practice.

Bondholders are the stakeholder group that tends to be recognized in the legal framework and has access to relevant information, including the right to send a representative to the annual general meeting. Performance enhancing mechanisms, such as stock options, are used in some countries to align the interests of managers and employees with shareholders. In Morocco, share options were introduced in 2001. However, they have been issued at a discount to prevailing market price. As a result, the incentive for managers to improve performance and increase share price is significantly reduced.

Section IV: Disclosure and transparency

Material information encompasses that which should be known by investors to formulate a rational investment decision. Improving the disclosure of material information provides investors with information to adjust their risk/reward perception. Incentives shape the approach to information disclosure. In countries where business has traditionally been based on relationship and trust, corporate information is thought of as secret; and it is accepted practice to keep different sets of books, e.g. one for taxes, one for outside investors, and one for the majority shareholder.

Information needs to be disseminated in a fair, timely and cost effective manner. Most of the countries surveyed only partially comply with international financial reporting standards. The assessments follow the recommendation of the Financial Stability Forum to adopt Internal Accounting (IAS) and auditing standards. Only Croatia is in full compliance with IAS, while most other countries differ in material aspects, including consolidation and segment reporting. In addition, the notes to the accounts are often only available to the public in summary form, if at all. Companies in Morocco and Egypt limit themselves to the publication of summary financial statements (sometimes with partial notes) in the newspaper or legal gazette.

Non financial information includes (i) company objectives, (ii) off balance sheet commitments and litigation risks, (iii) the ownership structure of the company, (iv) the remuneration of board members and key executives, (v) material foreseeable risk factors, (vi) material issues regarding employees and other stakeholders, and (vii) information on governance structures and policies. Disclosure of non-financial information is a new concept in most developing countries and transition economies. In Turkey, layoffs of more than 20 percent of the workforce, as well as collective bargaining agreements, must be disclosed. Malaysia and India require the disclosure of governance structures and policies under the listing rules as part of their code of best practice. The remuneration of board members and key executives is generally set by the AGM in the aggregate. South Africa followed a gradual approach in disclosure of board remuneration. The first King report, published in 1999, recommended that aggregate compensation be disclosed in the annual report of listed companies. The second King report, released in July 2001 calls for the disclosure of individual compensation.

Another set of issues relates to audit practices and the legal liability of auditors. The OECD Principles remain quite general on this point. In most of the countries surveyed, the legal and regulatory framework delegates the setting of accounting and auditing standards to the accounting association. Compliance is generally monitored by the securities regulator or, as in South Africa, to the stock exchange. Often these institutions do not have the necessary expertise to fulfill this obligation. The professional accounting and auditing bodies are in charge of monitoring members and their professional conduct. Generally, however, the monitoring is carried out by the same market practitioners that are being supervised. Also, professional associations often do not have the means to impose effective sanctions. A commendable exception to this rule is Morocco, although this is currently the subject of a dispute. On occasion, auditors have given unqualified opinions and certified that the accounts audited provide a fair and true picture, despite the fact that many defects were noted. The penalties for such behavior are low and enforcement generally lax. None of the countries surveyed has opted to set auditor liabilities at a high enough percentage of share capital to act as an effective deterrent.

While in theory most regulatory and legislative frameworks contain provisions defining auditor independence, this is often not a standard practice. Independence signifies the absence of direct or indirect personal and business relationships, past or current, between the audit firm, its partners, the company, its director and all related parties. In the aftermath of the Enron scandal,[13] it is likely that full disclosure of audit and all other fees paid to the audit firm will be adopted by a growing number of countries.

Section V : Responsibilities of the board

In most developing countries and transition economies, irrespective of their legal heritage, companies tend to follow a "parliamentarian model" of board representation, where directors represent the constituency that elected them. This model is not consistent with the four pillars of the OECD Principles.

In many countries, majority shareholders exercise significant influence over boards, directly as board members or indirectly through the appointment of board members who report to them. In this case it is difficult to hold the majority shareholder liable for his actions as a "shadow director."[14] Malaysia has attempted to subject shadow directors to statutory duties. The legal and regulatory frameworks in all assessed countries establish general duties for the board of directors. However, the prevailing legislation often does not spell out the key functions and there are no guidelines or procedures on how to fulfill these obligations. On the other hand, countries are beginning to introduce stiff penalties for board members without introducing the concept of the "business judgment rule." This rule allows directors to make business decisions without worrying about violating the duties of care and diligence, if they have acted on an informed basis, in good faith, and in the honest belief that the decision taken is in the best interests of the company. In the absence of such rule, directors may be discouraged from taking necessary decisions in the ordinary course of business.

One of the recurring themes on the subject of board duties across all regions is the lack of training and the limited understanding that directors have of corporate governance issues. According to market surveys, nine-tenths of directors do not feel that they are adequately informed or knowledgeable about their duties and responsibilities as a board member. One possible remedy is the creation of Institutes of Directors for training, dissemination of best practice and issuance of guidelines regarding the size of boards, the constitution of committees, and other useful practices. Training for directors is already mandatory in Malaysia.

In addition to defining strategy, selecting, monitoring and overseeing management is the most fundamental function of the board. A board that cannot dismiss management is not an effective board. This function requires an independence from management and controlling shareholders that is generally lacking in developing countries and transition economies. In many countries with single tier board structures, the chief executive officer (CEO) is also the chairperson of the board. In developing countries where ownership is highly concentrated, this person is often also a representative of the majority shareholders. This set-up makes it virtually impossible for outsiders to replace management because it would mean firing themselves. Therefore, the board fails in this fundamental respect. To change this situation, it is tempting to recommend that the function of CEO be separated from the function of chairperson of the board. However, experience in Morocco suggests that policy makers should carefully weigh the costs and benefits of making such a recommendation. In Morocco, the business community supported the separation of CEO and chair for the wrong reason, namely because it diminished the personal legal liability of the chairperson.' Under such circumstances, decoupling the two functions may be counterproductive. The accountability of board members to shareholders and stakeholders must first be firmly established. This may require legislative changes such as amending company law, or more vigorous enforcement of existing legislation. Then, decoupling is an option. Another approach to this problem is to set up a special purpose committee empowered to select and monitor key management.

While non-executive directors are frequent in the countries surveyed, very few are truly independent from the controlling shareholder or management. In contrast, the Kuala Lumpur Stock Exchange's listing requirements go beyond the norm by defining independent directors as "directors who are not officers of the company, who are neither related to its officers nor represent concentrated family holdings of its shares; who in the view of the company's board of directors, represent the interest of all public shareholders, and are free of any relationship that would interfere with the exercise of independent judgment."

Effective monitoring includes the detection and resolution of conflict of interests between managementiboard and shareholders/stakeholders, and prevention of any misuse of corporate assets and abuses in related party transactions. There is a growing consensus that board committees, such as recruitment, nomination, remuneration, risk management and audit committees with a minimum number of independent directors, can be useful to assure independence from management. In 11 out of 12 countries surveyed, the board does not effectively ensure the integrity of accounting and financial reporting systems, including oversight over the audit function. At this stage, there is no consensus as to what the optimal degree of independence should be. Some, like the Australian Institute of Directors, argue in favor of director expertise over independence: According to the Australian Institute, a majority of executive directors should be elected to key committees, such as the audit committee. Others, like the American National Association of Corporate Directors favor a majority of independent directors. In developing countries and transition economies, the pool of available financially numerate independent directors is often limited. The Australian approach is, therefore, perhaps more realistic. According to the OECD Principles, board members must have access to accurate, relevant and timely information, including management accounts and advice from outsiders. In most countries with unitary boards that were surveyed, access to information is assured since most board members are insiders. However, information is not always readily available in countries with supervisory boards. Directors should also devote sufficient time to their responsibilities. Board meetings are still often considered a formality and not convened with sufficient frequency. Directors do seldom adequately prepare themselves for board discussions, and boards are often too large to be effective. One possible remedy is to introduce a requirement in the listing rules that companies publish information on the frequency and attendance of their board meetings in their annual report.

Uses in Policy Dialogue and Implementation of Better Corporate Governance Practices

The corporate governance assessments have a number of applications for International Financial Institutions, policy makers and the private sector. They support diagnostic and strategic work, underpin policy dialogue and lending operations, and provide input to technical assistance and capacity building efforts. They are useful for companies who want to capture reputational benefits by improving their internal corporate governance structure.

Diagnosis, strategy and lending operations

The corporate governance assessments can be seen as building blocks for diagnostic work, such as investment climate assessments. They are useful inputs into key policy documents, such as sectoral strategies for the private and financial sectors or country wide development strategies. Their strengths lie both in the systematic standardized coverage and in their benchmarking against an internationally recognized standard, and they provide an easy guide to policy dialogue and reform. The assessments complement the OECD/World Bank Regional Roundtables on Corporate Governance. The assessments provide country specific diagnostics, while the roundtables focus on regions.

In addition to their diagnostic and strategic value, corporate governance country assessments are valuable inputs into lending operations. In the World Bank, for example, the country program cycle has become the most important business model. Programmatic adjustment lending has been found to be a cost-effective vehicle for supporting the Bank's policy dialogue with its clients on the social and structural agenda and for partnering with other agencies. The country has replaced the project as the critical focus of implementation. The programmatic approach of the World Bank has four main steps[19] - definition of the vision; diagnosis prepared and shared with clients and partners [20]; programming; and monitoring. Corporate governance country assessments are useful for the definition of the vision (aspiration to comply with international standards). During the diagnostic phase, they provide critical and objective information on the strengths and weaknesses of the economy under review, including the functioning of the private sector and securities market. During the programming phase, the assessments provide valuable input into the design and sequencing of operations. During the monitoring, they provide clear progress benchmarks to monitor the outcome of the programs.

Technical assistance and capacity building operations

Corporate governance country assessments directly identify technical assistance and capacity building needs, which can be financed through operations from International Financial Institutions, bilaterals or the private sector. An example of a multi-donor trust fund is the World Bank/OECD Global Corporate Governance Forum, which is set up to disseminate best practice and raise awareness of the need for reform; foster academic research; and provide a source of finance for implementation of reform and capacity building.

Measures proposed in the assessments include setting up institutes of directors; training securities regulators and commercial courts' magistrates; introducing arbitration procedures; strengthening the association of accountants and auditors; assisting with the drafting of a code of best practice (see box IV); advising on the govemance of the securities regulator and the stock exchange; training the financial press and setting up institutions that actively defend shareholders rights.

Box IV : **Codes of best practice**

A code of best practice is a useful tool to complement the existing legal, regulatory and institutional framework underpinning corporate governance. Codes have been issued by companies seeking to differentiate themselves from their competitors in terms of corporate responsibility (General Motors, Royal Dutch Shell), by stock exchanges, a special purpose commissions set up by the private and the public sectors. A number of countries have issued national codes of best practice for corporate governance inspired from the OECD principles. These include Brazil, India, Poland, the Czech Republic, Malaysia, Russia, and China, among others. While such codes are rooted in the OECD Principles, some of them go further. For example, India and South Africa require disclosure on individual emoluments of directors, including stock options - the OECD Principles do not. Likewise, in Brazil, the Novo Mercado requires issuers to adhere to the one-share-one-vote principle - the OECD Principles do not.

Codes of best practice are rules which go beyond the law. They are an instrument for improving behavior based on evolving best practice. They consist of guidelines concerning the selection, composition, and remuneration of the board of directors, the role and composition of board committees, the definition of "independence", the treatment of shareholders and stakeholders, accounting standards, financial and non financial reporting and disclosure policies. Compliance with the code is usually voluntary. In Malaysia and Singapore, the securities regulator and/or stock exchange require issuers to disclose the extent to which they comply with the code in their annual report and explain divergences, or to publish a separate report on corporate govemance. In countries such as India and Brazil some of the recommendations of the code have been picked up by the securities regulator or the stock exchange and made mandatory through the listing requirements (e.g. minimum number of independent directors)

The corporate governance assessments can improve the targeting of training by identifying areas where enforcement needs strengthening or capacity building is needed. Once the required training has been identified, the efficiency and targeting of training delivery can be increased by borrowing aspects of the "output-based" approach to financing service delivery - allowing suitable institutions to compete for the delivery of the required training, and linking the compensation of the trainers at least in part to the number of students successfully accredited in the required skills.

A summary of follow up operations with a corporate governance dimension in client countries of the World Bank is set out below (see Table 2).

Table 2 : **Summary of Follow-up Requests and Operations in Selected Countries**

Brazil	• *Follow-up* : programmatic financial sector adjustment loan with corporate governance issues embedded in the securities market thematic area has been negotiated. • *Follow-up* : TA project supporting implementation of the financial sector reform program by the Central Bank and the securities regulator (CDVM) negotiated.
Bulgaria	• *Follow-up* : ➾ PAL will likely include conditionalities related to revisions of the commercial and securities legislation. ➾ Approximately $25,000 in PHRD is being used to finance international consultants on revisions to the commercial law.
Cambodia	• *Follow-up* : IDF grant to improve accounting standards and financial reporting.
China	• *Request* : TA for development of director training for securities commission and for establishment of a director institute. • *Follow-up* : legal reform program focusing on corporate law.
Croatia	• *Follow-up* : recommendations regarding revisions to the company law are to be included in the structural adjustment loan under preparation.
Czech Republic	• *Request* : World Bank to play role of facilitator to reconcile two separate codes of corporate governance.
Egypt	• *Follow-up* : IDF approval for $247,000 for Institute of Directors (loD).
Indonesia	• *Request* : TA for curriculum development, trainer training, and provision of guest trainers to the Indonesian Institute of Corporate Directorships. • *Follow-up* : ➾ advice to high-level national committee on corporate governance; ➾ support for new corporate law and identification of listing criteria for the Jakarta stock exchange; and

- ⇛ project component to strengthen the capacity of commercial courts by training judges and staff.

Korea • *Follow-up* :

- ⇛ significant components on corporate governance and transparency reforms under SAL I and SAL II;
- ⇛ ASEM grant ($300,000) to the Korean Institute of Certified Public Accountants to develop a CPE program and other educational material to improve auditing practices; and
- ⇛ PHRD Special ($750,000) to support establishment of the Korean Accounting Standards Board and improve the effectiveness of FSS on supervision of disclosure and financial reporting practices.

LAO P.D.R. • *Follow-up* **:** $300,000 IDF grant on improving financial accountability under preparation.

Mauritius • *Request* **:** TA for Institute of Directors (loD).

Philippines • *Follow-up* :

- ⇛ Corporate governance issues will be addressed when an adjustment operation goes forward (CAS envisions adjustment loan in FY03);
- ⇛ Sector specific issues will be handled under SCAL, SILS and APLS; and
- ⇛ In economic and sector work, ongoing grant to support Institute of Directors (loD).

Thailand • *Follow-up* :

- ⇛ Significant component on corporate governance reform under EFAL I and EFAL 11;
- ⇛ ASEM grant ($400,000) for development of course syllabus and materials for the Institute of Directors (loD);
- ⇛ IDF grant ($350,000) to improve financial reporting and audit for listed companies;
- ⇛ Significant component on corporate governance reform under the Country Development Partnership on Competitiveness; and
- ⇛ PHRD Special ($750,000) to improve application of new and improved accounting and auditing standards through a CPE and a CMA program, as well as to develop guidelines for financial reporting of SME.

Ukraine • *Follow-up* : programmatic lending operation with corporate governance issues embedded as milestones and reform actions.

Vietnam • *Follow-up*: IDF grant ($300,000) on improving financial accountability.

Open Issues and Next Steps

To enhance the relevance of the OECD Principles for the developing countries and transition economies, the concept of choice and the problems associated with enforcement need to be debated.

Choice

One fundamental issue that arises from the corporate governance assessments is that choice, in the form of different corporate governance options offered to issuers, is an effective mechanism to facilitate reform. More generally, a "menu of options" approach provides a means for issuers and investors to choose the markets and the companies that are most appropriate for their specific risk profile. At the same time, standardization of options is desirable to lower transaction costs for issuers and investors alike.

Issuers

All over the world, companies have a choice when incorporating. They can decide to incorporate as partnerships, limited liability companies or other forms permitted under the law. Each form of incorporation carries different obligations. Depending on the amount and kind of outside financing needed, companies will choose the form of incorporation that is best adapted to their needs. Choice is therefore essential.

Choice is also desirable because it allows incentives for market participants to play their part. Issuers who want to attract portfolio investment have an incentive to adapt to norms that satisfy such investors. A stock exchange which allows listed companies to choose between different level of disclosure and corporate governance standards through several compartments, provides an opportunity for those companies opting for the compartment with the highest standards to signal to investors that they are different from the majority of listed companies in their country. Such companies may therefore be able to raise capital more easily, lower their cost of capital and attract high quality long term investors, such as pension funds, to become shareholders in their company. This approach is attractive because it provides a non-coercive mechanism for pulling the country's corporate governance upward gradually by leveraging reputational costs and benefits. An example of such an approach is the recent introduction by the Brazilian stock exchange of a new compartment called the Novo Mercado, which is discussed in Box II. The companies listed on the Novo Mercado are prohibited from issuing non-voting shares, while companies on the main board may do so. They have to abide by US or international accounting standards, and their free float must be at least 25 percent. An arbitration panel has also been created to settle shareholder disputes.

At the other end of the spectrum, some companies may not be ready, willing and able to comply with the minimum standards of disclosure, transparency and accountability prescribed in the OECD Principles, let alone those required by the "top compartment" of the exchange; however, they may still wish to provide some limited liquidity to their shareholders. This objective can be achieved by introducing an Over the Counter compartment, which provides limited disclosure standards to investors but allows them to offer their shares for sale through an organized market. This approach has been followed successfully by the Prague Stock Exchange.

Investors

Investors have different risk profiles. Some are attracted by high-risk/high returnsinvestment opportunities; some are more risk averse. Investors are sometimes willing to invest their savings in a company where the degree of transparency is limited, because they have high confidence in the incumbent management team or because they perceive the sector in which the company operates to be bearing, Allowing different models of corporate governance to co-exist provides a "horses for courses" approach and permits investors with different risk profiles to choose the appropriate market and company to invest in and allows market forces to pick the winners.

In addition, some developing countries with dynamic capital markets such as Chile have liberalized their capital accounts, thereby allowing investors to invest their savings abroad. This approach may not be appropriate for all developing countries and transition economies. However, when this is possible, one of the main benefits of this approach is that it provides alternative means of promoting equitable treatment of shareholders and creates strong incentives for both issuers seeking capital, as well as national regulators that desire to promote overall economic fundamentals, to ensure that their financial systems comply with international financial standards.

Enforcement

In South East Asia and Latin America, firms are often organized in business groups. These groups grow internally, constructing a web of companies that support the group. At the apex of the group is a large enterprise controlled by a family which plays a corporate finance function for smaller companies by financing suppliers and new firms and cushioning financial downturns. In Latin America and the Middle East, a bank or an insurance company is often added to the group. Hence, there are cross-shareholdings to finance growth. This system of internal corporate governance, while not transparent to the market, substitutes for a weak external corporate governance framework, where the legislative framework is inadequate or enforcement of the law is weak.

Business groups function on the basis of proprietary information. Further discussion is required to determine whether rules and regulations concerning the dissemination of information and disclosure and transparency need to be adapted to these circumstances. Similarly, in countries with weak regulatory environments, concentrated enforcement through the market regulators may be preferable.

In developing countries and transition economies, where the legal and regulatory framework is evolving, the question arises whether policy makers should rely on judges or regulators to enforce laws and contracts. At this stage of development, courts are often under-financed, unmotivated, unclear as to how the law applies, unfamiliar with economic issues or even corrupt.[21] Experience shows that in these circumstances the incentives of regulators to enforce the laws may be greater than those of judges. Judges are faced with a broader set of trade-offs and are less focused on issues of corporate governance than specific regulators for securities markets, or special courts for securities markets. It may therefore be more advantageous to rely on regulatory agencies until the judicial system becomes efficient. This only works, however, if the regulators can enforce sanctions without their verdicts being subject to automatic appeal. In Poland, strict enforcement of the securities law by a highly motivated regulator was associated with a rapidly developing stock market. In the Czech Republic, hands-off regulation and reliance on the court system was associated with a moribund stock market. [22]

Other issues

There are some areas where the OECD Principles remain open to interpretation. In some of these, differences of opinion remain while in others there appears to be some convergence towards more precise definition.

The rights of shareholders to dividends

One example where the OECD Principle need clarification is the Principle stating that basic shareholder rights include the **right to share in the profits** of the corporation. In some countries who contributed to the drafting of the Principles (The USA or the UK, for example) and subsequently endorsed them, shareholders do not decide on profit distribution. This is the prerogative of the board of directors. Shareholders only have the right to approve the proposal of the board. They can lower the dividend proposed, but can neither increase it nor insist on a distribution if management decides to retain earnings for investments. The right to dividends is an economic right subject to the decision of management. In other countries, for example France, the shareholders assembly can impose a dividend distribution on the board of directors.

Shareholders' rights and capital increases

Another example where differences of opinion have emerged is the issue of **capital increase**. The OECD Principles state that shareholders should have the right to participate in fundamental corporate changes. They do not specify whether and how capital increases should be put to the vote of shareholders. It has been argued in some quarters that capital increase should require a supermajority (75 percent of outstanding shares) vote by shareholders. Others argue that such rule is impractical and restricts management in the exercise of its duties.

Disclosure of executive compensation

In the case of disclosure of **compensation for directors and executives,** the OECD Principles simply state that "sufficient information" should be disclosed to shareholders. Since their publication, there is a growing consensus that individual compensation packages should be disclosed in detail.

Equitable treatment

One of the benefits of equitable treatment of shareholders is that it fosters risk diversification for all shareholders. In a system where control rights of some shareholders ensure that they obtain a disproportionate share of the control premium, those who own shares with control rights have no incentives to diversify their investments. If on the other hand, there is only one single class of shares with the same voting rights and if the rules governing takeovers ensure that control premiums are distributed to all shareholders of the target company equally, the trade-off between concentration of voting rights and risk diversification is reduced. This is one argument in favour of "one share-one vote." The OECD Principles do not prescribe one-share-one vote; they merely require disclosure when there is a deviation from this principle. Some quarters are vocal on this issue, insisting on a change of laws where multiple or non-voting shares are permitted. Others argue that the market should be left to penalize issuers that deviate from the one-share one vote principle.

Other mechanisms to promote the equitable treatment of shareholders include mandatory tender offers for acquirers that obtain control of a company. This rule permits minority investors to participate in the control premium paid for acquiring control of a company. On the other hand, the imposition of a mandatory tender offer rule may make it easier to frustrate hostile bids in markets with weakly developed capital markets, thereby providing more power to the company's directors at the expense of shareholders, and make it more difficult for *any* shareholder to realize a premium over the current price.

Appendix A

List of Standards and Codes Assessed by IMF and World Bank

Group A : Transparency Standards (assessed by the IMF, including under the FSAP)

- *Data Dissemination* : the Fund's Special *Data Dissemination Standard/General Data Dissemination System* (SDDS/GDDS).
- *Fiscal Transparency* : the Fund's *Code of Good Practices on Fiscal Transparency.*
- *Monetary and Financial Policy Transparency* : the Fund's *Code of Good Practices on Transparency in Monetary and Financial Policies* (usually assessed under the FSAP).

Group B : Regulatory and Supervisory Standards (assessed under the FSAP)

- *Banking Supervision* : Basel Committee's *Core Principles for Effective Banking Supervision* (BCP) (usually assessed under the FSAP).
- *Securities* : International Organization of Securities Commissions' (IOSCO) *Objectives and Principles for Securities Regulation*.
- *Insurance* : International Association of Insurance Supervisors' (IAIS) *Insurance Supervisory Principles.*
- *Payments Systems* : Committee on Payments and Settlements Systems' (CPSS) *Core Principles for Systemically Important Payments Systems*.

Group C : Market Infrastructure Standards (assessed by the World Bank, including under the FSAP)

- *Corporate Governance* : OECD *Principles of Corporate Governance.*
- *Accounting* : International Accounting Standards Committee's *International Accounting Standards.*
- *Auditing* : International Federation of Accountants' *International Standards on Auditing.*
- *Insolvency & Creditor Rights* : World Bank *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*.

Group D : Market Integrity Standards (currently under consideration for ROSCs)

- *Money Laundering* : Financial Action Task Force (FATF) on Money Laundering *FATF 40 Recommendations* - preparation of ROSC modules under the aegis of the FATF currently under consideration.

WPS2837	Reform, Growth, and Poverty in Vietnam 37471	David Dollar	May 2002	E. Khine
WPS2838	Economic Mobility in Vietnam in the 1990s	Paul Glewwe Phong Nguyen	May 2002	E. Khine 37471
WPS2839	Marketing Externalities and Market Development	M. Shahe Emran Forhad Shilpi	May 2002	F. Shilpi 87476
WPS2840	Public Spending and Outcomes: Does Governance Matter?	Andrew Sunil Rajkumar Vinaya Swaroop	May 2002	H. Sladovich 37698
WPS2841	Contractual Savings in Countries with a Small Financial Sector	Gregorio Impavido Alberto R. Musalem Dimitri Vittas	May 2002	P Braxton 32720
WPS2842	Financial Sector Inefficiencies and the Debt Laffer Curve	Pierre-Richard Agenor Joshua Aizenman	May 2002	M. Gosiengfiao 33363
WPS2843	A Practical Guide to Managing Systemic Financial Crises' A Review of Approaches Taken in Indonesia, the Republic of Korea, and Thailand	David Scott	May 2002	L. Yeargin 81553
WPS2844	Money Demand in Venezuela. Multiple Cycle Extraction in a Cointegration Framework	Mario A. Cuevas	May 2002	M. Geller 85155
WPS2845	The Spatial Division of Labor in Nepal	Marcel Fafchamps Forhad Shilpi	May 2002	F. Shilpi 87476
WPS2846	Is India's Economic Growth Leaving the Poor Behind ?	Gaurav Datt Martin Ravallion	May 2002	C. Cunanan 32301
WPS2847	The Nature and Dynamics of Poverty Determinants in Burkina Faso in the 1990s	Hippolyte Fofack	May 2002	P. White 81131
WPS2848	Administrative Barriers to Foreign Investment in Developing Countries	Jacques Morisset Olivier Lumenga Neso	May 2002	M. Feghali 36177
WPS2849	Pooling, Savings, and Prevention: Mitigating the Risk of Old Age Poverty in Chile	Truman G. Packard	May 2002	T. Packard 75841
WPS2850	Determinants of Commercial Bank Performance in Transition: An Application of Data Envelopment Analysis	David A. Grigorian Vlad Manole	June 2002	S Torres 39012
WPS2851	Economic Development and the World Trade Organization After Doha	Bernard Hoekman	June 2002	P. Flewitt 32724
WPS2852	Regional Agreements and Trade in Services: Policy Issues	Aaditya Mattoo Carsten Fink	June 2002	P. Flewitt 32724
WPS2853	Private Interhousehold Transfers in Vietnam in the Early and Late 1990s	Donald Cox	June 2002	E. Khine 37471

WPS2854	Rich *and* Powerful Subjective Power and Welfare in Russia	Michael Lokshin Martin Ravallion	June 2002	C. Cunanan 32301
WPS2855	Financial Crises, Financial Dependence, and Industry Growth	Luc Laeven Daniela Klingebiel Randy Kroszner	June 2002	R. Vo 33722
WPS2856	Banking Policy and Macroeconomic Stability: An Exploration	Gerard Caprio, Jr. Patrick Honohan	June 2002	A. Yaptenco 31823
WPS2857	Markups, Returns to Scale, and Productivity. A Case Study of Singapore's Manufacturing Sector	Hiau Looi Kee	June 2002	M Kasilag 39081

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1. G7: Canada, France, Germany, Italy, Japan, UK, USA. G20: G7 plus Argentina, Australia, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, EU. IMF and World Bank participate in the discussions. G22: G7 plus Argentina, Australia, Brazil, China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand.
2. The full list of the 11 standards is set out in Appendix A. Money laundering, a potential 12'h standard, is currently under consideration for inclusion in the ROSC exercise.
3. Source: Preface to the OECD Principles.
4. Source:OECD Principles
5. Source: Ibid
6. Corporate govemance experts from the World Bank Group, the OECD, the IMF, the Commonwealth Association, the US Securities Commission, as well as private sector experts of corporate governance from industrialized and developing countries, were asked to provide guidance and opinions.
7. The free float is that portion of capital which is not held by controlling shareholders and can be easily purchased by portfolio investors.
8. Cumulative voting allows minority shareholders to cast all their votes on one single candidate. Suppose that a publicly traded company has two shareholders, one holding 80% of the votes and another with 20%. 5 new members of the Board need to be elected this year. If there is no cumulative voting rule in place, each shareholder will have to vote separately for each Board position. The majority shareholder will get all 5 seats, since he will outvote the minority shareholder each time by 80:20. With cumulative voting in place, the minority shareholder can decide how to place her votes. The optimal strategy for her would be to take all her votes (5 times 20%) and place them on one Board member. The minority shareholder will then win that seat, since she will have 100%.
9. "Latvia, Lithuania and South Africa are not finalized.
10. "Incomplete" means that some provisions are in place, while others may not be.
11. As of January 2002, an additional score, "partially observed," has been introduced for cases when a principle is less than "largely observed," but better than "materially not observed."
12. Non voting PN shares can constitute up to 2/3 of total share capital. The new corporate law lowers this limit to 50 percent.
13. Defined as 25 percent or more of company assets.
14. In the fall of 2001, Enron, the US energy trading company, filed for protection from creditors under Chapter 11. It transpired that, with the connivance of its auditor, the company had used off balance sheet subsidiaries to hide the amount of debt that the company had accumulated. Such practices had prevented shareholders from gaining a full and fair picture of the company's financial situation until it was too late.

15. "Shadow directors" are controlling shareholders or shareholders with significant influence over the control of the company, who exert influence over the board even though they are not de facto directors.
16. For this reason a number of companies have opted for the two tier board structure.
17. Source: Klaus Tilmes, Ivan Velev and Karim Gigler, May 2001 .World Bank Documents: Programmatic Lending: Review of Recent Bank Documents.
18. Due diligence and other diagnostic economic and sector work (ESW).
19. Coase versus the Coasians, Edward Glaeser, Simon Johnson, Andrei Shleifer (2001).
20. Ibid.

SECURITIES LAWS AND MARKETS — GLOBAL BENCHMARKING

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"Whatever is not there in India, it is not there in the World." This adage cannot be truer for the Indian Securities Market.

INTRODUCTION

Benchmarking is a management exercise of systematically identifying the best practices and standards followed by the leaders and endeavouring to meet or even surpass such standards. The leader may be an individual, an entity, a market or a system which is the best today at some functions and tasks, and not necessarily in all areas and for all times to come. Hence, benchmarking continuously searches for the today's leaders in each area and identifies today's best practices / standards. Global benchmarking means searching for global leaders in each area to identify the global best practices / standards. It may, however, be noted that the best standard / practice followed by the leader may not be the best in the absolute sense or for all the environments. In such a case, the best practice may not be adopted at all or may be adopted with suitable modifications to match the host environment.

In the context of securities laws and markets, while the laws and the markets as a whole are benchmarked against the best jurisdictions, each practice or standard is benchmarked against the best practice / standard across the jurisdictions. The benchmarking is generally done against three main planks, namely other domestic laws and markets, overseas securities laws and markets, and the international standards. For example, domestic laws provide for a system of ombudsman or consumer fora to redress consumer grievances and a scheme of compensating depositors if a bank goes bankrupt. Some overseas jurisdictions have a practice of plea bargaining, which lets off an offender who simply pays up without admitting the offence. The IOSCO and other international agencies have laid down international standards such as the 'IOSCO Objectives and Principles of Securities Regulation', 'Recommendations for Securities Settlement Systems (SSS)' etc. The benchmarking identifies the best standards and practices from these three sources and adopts them, with or without modifications, keeping in view the uniqueness of the host market. For example, net worth determines the exposure of the brokers in some jurisdictions. A modified practice is, however, in vogue in the Indian securities market where the deposits with the exchanges determine the exposure of the brokers. This paper attempts to benchmark the Indian securities laws and markets against overseas securities laws and markets and the international standards to identify the best practices and standards followed elsewhere or recommended by the international standard setting agencies. It benchmarks the Indian securities laws and markets in respect of securities laws, securities regulations, market design and market outcome and makes a few suggestions to bring the Indian securities laws and markets to the global standards.

Given the importance of the securities market in the economy and the need of the Indian economy to grow at projected 8% per annum, the authorities have been promoting the securities market as an engine of growth to provide an alternative but efficient means of resource mobilization for the corporate sector and the government. The Government, the regulator and the market participants have been continuously benchmarking the systems, laws and regulations and practices and standards to improve the safety and efficiency of the market. They have ushered in as many as nine special legislative interventions during the last decade to which there is no parallel any where in the world. The Indian securities market gave birth to the first ever demutualised stock exchange in the world and today all stock exchanges in India are corporatised and demutualised. It used the satellite based

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communication technology for securities transactions for the first time. It started the real time on line position monitoring system for brokers. It is the first to introduce the straight through processing in securities transactions. It is the first major market to have implemented T+2 rolling settlement. In many areas such as biometric based identification of market participants, corporate governance rating, etc. Indian market is the best in the world. These have yielded considerable benefits to the market as evidenced by the growth in the number of market participants, growth in volumes in securities transactions, increasing globalization of the Indian market, reduction in transaction costs, significant improvements in efficiency, transparency and safety, and level of compliance with international standards and have earned for the Indian securities market a place of respect amongst the comity of securities markets in the world. By benchmarking itself during the last one decade, it has now become a benchmark for many overseas markets.

The striking manifestations of the benchmarking are:

(a) All participants as well as their activities have a sound legal basis.

(b) The laws and regulations substantially comply with the 30 IOSCO Principles of Securities Regulations.

(c) The market is a complete market in the sense that it offers all kinds of securities and derivatives thereon to meet every possible need of issuers and investors.

(d) The market uses information technology intensively and extensively, while most of the operations are automated.

(e) An estimated 20 million investors invest through the securities market.

(f) The securities are issued, traded and settled in demat form.

(g) The securities are issued through book building process.

(h) All stock exchanges are corporatised and demutualised. All of them provide screen based trading system and guarantee settlement of all trades. Most of the trades are cleared and settled through a clearing corporation.

(i) It ranks first in terms of number of companies listed on the exchanges.

(j) The market capitalization of listed securities far exceeds the aggregate deposits with the banking system. According to Global Stock Markets Factbook 2005, India ranked 18th among the securities markets in terms of market capitalization as at end December, 2004.

(k) According to Global Stock Markets Factbook 2005, India ranked 18th among the securities markets in terms of turnover and 15th in terms of turnover ratio during 2004. It accounted for 0.96% of world turnover and 9.6% of emerging markets turnover in 2004.

(l) Though the trading in derivatives on securities commenced in 2000, the volume in derivatives far exceeds the volumes in cash market.

(m) NSE and BSE rank among the top 5 exchanges in the world in terms of number of transactions in the equity cash market. NSE is the largest exchange in the world in stock futures and the third largest in index futures.

(n) The Nifty impact cost reduced to 0.09% in 2004 reflecting substantial improvement in liquidity. The brokerage has reduced to as low as 0.15%. The transaction costs on Indian exchanges are one of the lowest among the major markets.

(o) The stock exchanges have the most advanced and scientific risk management system which levies VaR based margin on the portfolios at client level on a real time basis.

(p) Indian securities market has 6.9% weightage in S&P/IFCG Composite Index of emerging stock markets.

(q) The GSCS settlement benchmark improved from –16.8 in 1995 to 93.1 in 2004. The securities settlement system substantially complies with the G30, BIS-IOSCO and ISSA Recommendations.

(r) A study by Prof. Marti Subrahmanyam involving 500 ADRs has revealed that ADRs of Indian stocks are paid the highest premium in relation to the domestic prices of equity shares of the respective companies.

(s) According to the World Bank, with net inward portfolio equity flows of US$ 7 billion in 2003, India accounted for 48.95% of the net inward portfolio equity flows to all developing countries.

(t) In terms of the FDI Confidence Index (AT Kearney), India rose to the third most likely FDI location in 2004, just behind China and United States. CALPERS gives a score of 3 (the maximum that could be awarded) via Permissible Equity Market Analysis while voting for India as an investment destination. FDI inflow has been consistently over US $ 5 billion every year over the last 4-5 years.

(u) Domestic issuers / investors have the choice to raise resources / invest within / across the borders. Overseas issuers and investors have access to the Indian market also.

(v) In a study: "What works in Securities Laws?" Professors Rafael La Porta, Florencio Lopez – de-Silanes, and Andrei Shleifer, have observed: "India scores 100% as far as disclosure standards are concerned".

(w) CLSA-CG Watch, in its September 2004 report, describes: "In terms of consolidation, segmental reporting, deferred tax accounting and related party transactions, the gap between Indian and US GAAP is minimal."

(x) The Economic Intelligence Unit 2003 Study: The Asian Experience states: "Top of the country class, as might be expected is Singapore followed by Hong Kong and, somewhat surprisingly, India where overall disclosure standards have improved dramatically, accounting differences between local and US standards have been minimized and the number of companies with a majority of independent directors has risen significantly."

(y) CLSA-Emerging Markets Study on Corporate Governance gives India a score of 6.2 which is next only to 7.5 of Singapore and 6.7 of Hong Kong. It observes: "India's stock market regulatory authority, the Securities and Exchange Board of India continues to raise the bar for good corporate governance".

(z) In the context of innovations of recent times in raising the risk capital, the Financial Times, London, dated 31st July 2004, observed: "World's Biggest Democracy can show Google how to conduct an online IPO.…in India you cannot apply on the web but investors can access one of the world's largest financial networks with 7000 terminals scattered around 350 cities. And every step of the book building process is public. ...The Indian system is a refreshing example of a transparent IPO market but it is also a rare one, especially in the insider-friendly Asian markets."

SECURITIES LAWS

The securities laws, comprising of four main legislations, namely the SEBI Act, 1992, the Companies Act, 1956, the Securities Contracts (Regulation) Act, 1956 (SCRA) and the Depositories Act, 1996, govern the securities market. The SEBI Act, 1992 establishes SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market. The SCRA provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent undesirable transactions in securities. It gives central government/ SEBI regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. The Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities of public limited companies freely transferable subject to certain exceptions; (b) dematerialising the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. The Companies Act, 1956 deals with issue, allotment and transfer of securities and various aspects relating to company management. It prescribes the standards of disclosure in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, management perception of risk factors, etc.

Though there is no fixed set of global benchmarks in securities laws, the benchmarks can be derived from the standards / practices in vogue in the best jurisdictions. They generally provide a sound legal basis for (i) enacting, enforcing and upholding laws relating to securities market and the authorities responsible for establishing the rule of law, (ii) establishing autonomous regulator(s) and self regulatory organizations and empowering them to regulate and supervise the markets and the participants effectively, (iii) setting up of institutions such as exchanges, depositories, clearing corporations, etc. and their efficient operations, (iv) regulation and supervision of market intermediaries such as collective investment schemes (CIS), merchant bankers, brokers, etc. and their efficient operations, (v) various activities and operations in the market such as issue, listing, delisting, trading, clearing, settlement, transfer and dematerialisation of securities, (vi) prohibition of malpractices such as insider trading, fraudulent and unfair trade practices, etc. (vii) expeditious and effective enforcement actions in case of misdemeanour, and quick resolution of disputes, (viii) supporting developmental initiatives, (ix) protecting the interests of investors in securities and (x) ensuring that the laws are transparent and publicly accessible. Indian securities laws provide a sound legal basis for all these purposes.

A few examples are presented here to illustrate the global standards in vogue in the Indian securities laws. The Constitution of India unambiguously authorizes the Central Government to make laws relating to the securities market. The laws made by the central government have empowered various authorities namely, Department of Economic Affairs (DEA), Department of Company Affairs (DCA), Reserve Bank of India (RBI) and SEBI to supervise and regulate different areas in the securities market and make subordinate legislations for this purpose. The laws as well as subordinate legislations and the enforcement actions of the authorities are subject to judicial scrutiny. The SEBI Act provides the legal basis for the establishment of SEBI, its powers and functions, and its operational standards. Similarly, the SCRA and the Depositories Act provide for establishment of the stock exchanges and the depositories respectively as well as their responsibilities and operational standards. The law confers on SEBI, exchanges and depositories adequate powers to frame rules, regulations, and byelaws to govern their operations and regulate the conduct of their constituents.

The best regulators are autonomous and act without fear of, or favour to, any quarter. The regulator can have autonomy if it does not depend on the government for its sustenance, and it has freedom to frame regulations and implement them without fear or intervention of the government. The SEBI Act ensures an independent stream of income for the regulator. The regulator has substantial powers of subordinate legislation. The power of the Government is limited to giving directions on questions of policy and superceding the regulator for a period not exceeding six months in case of grave emergencies. In order to avoid conflict of interests, the regulator does not appropriate the penalties levied by it on the miscreants. However, to ensure its accountability, the law requires that all the regulations made by the regulator are laid before each House of the Parliament for scrutiny and enforcement orders can be appealed before a specialized tribunal.

The best regulators have all the relevant powers to achieve their assigned objectives, with an appropriate mechanism to ensure that the power is not misused or exercised beyond what is warranted. The law empowers the regulator in India to register, regulate and supervise all the market participants including exchanges, depositories, intermediaries and persons associated with the securities market like foreign institutional investors, credit rating agencies, venture capital funds, etc. and their operations. It has blanket authority to regulate other intermediaries or persons, not named specifically in the statute, by specifying them through a notification. Its regulatory jurisdiction extends over corporates in the issuance of capital, transfer of securities and other related matters. It can conduct enquiries, audits, inspections and investigations, including search and seizure, of all concerned in discharge of its duties.

The law provides a penal framework and empowers the regulator to penalise all participants, including intermediaries and companies, in case of violations of the provisions of the Act, Rules and Regulations made thereunder to ensure good conduct in the interests of investors and orderly growth of the securities market. It has a wide choice of penalties, which include prosecution, suspension or cancellation of registration, monetary penalty, directions, cease and desist orders, etc. In order to ensure that the enforcement action is fair and objective, any person aggrieved by an order of the regulator under the securities laws can prefer an appeal before the Securities Appellate Tribunal (SAT).

The law prohibits trades in securities outside the recognized stock exchanges. The exchanges frame and enforce rules to regulate and supervise the trading on exchanges, admission and conduct of the trading members and listing and delisting of securities. The Rules may not always further the public interest (interests of investors and society) and the private interest (interests of trading members) simultaneously. In a mutual structure, private interest may get precedence over public interest. In order to avoid such possibility, the law mandates all exchanges to be corporatised and demutualised by a specified time. All exchanges are now corporatised and demutualised. The law also provides a framework for clearing corporations and the regulatory framework for the same is being developed. As soon as clearing corporations are recognized, the clearing and settlement functions would be transferred from exchanges to clearing corporations.

The Depositories Act provides a legal basis for the establishment of multiple depositories and entrusts them with the responsibility of maintaining ownership records of securities and effecting transfer of securities through book entry only. The depositories render, through participants, any service connected with the recording of allotment of securities and transfer of ownership of securities. The Depositories Act read with the Companies Act have made the securities of all public companies freely transferable. That is, once the agreed consideration is paid and the purchase transaction is settled, the buyer is automatically entitled to all the rights associated with the security. Only if the transfer is in violation of any law, the depository, depository participant, company, SEBI or investor can apply to the Company Law Board within 2 months for rectification of records.

The law provides statutory backing to listing and delisting of securities in the interests of investors. It empowers the authorities to prescribe conditions for listing and delisting. The listed companies are obliged to comply with a set of conditions in the interests of investors. The law also allows delisting of securities under specified circumstances. Similarly, the law provides legal backing for different products. For example, the law supports trades in derivatives explicitly, even though these, being cash settled, could be construed as wagers which are null and void under the general law.

The securities laws in India has evolved over time to meet the emerging deficiencies, improve the safety and efficiency of operations, accommodate new products and market designs, adopt the best practices from the best jurisdictions and to implement international standards. For example, a statutory regulator was created in 1992 to regulate the market participants in the interests of investors in securities and orderly development of the securities market. Its powers and jurisdiction were enhanced by legislations in 1995, 1999 and 2002. The Capital Issues (Control) Act, 1947 was repealed in 1992 to pave the way for market determined allocation of resources. The Depositories Act was enacted in 1996 to provide for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security. The law was enacted in 1999 to provide a legal framework for trading of derivatives of securities and units of collective investment scheme. It was further amended in 2004 to mandate corporatisation and demutualisation of stock exchanges and to enable transfer of clearing and settlement function to clearing corporations. This also provided a legal basis for delisting of securities.

SECURITIES REGULATIONS

In order to meet the exigencies of the market and to provide flexibility to the regulators, they have been delegated substantial powers of subordinate legislation. Government has framed rules under the SCRA, the SEBI Act and the Depositories Act. SEBI has framed 27 regulations, 6 guidelines, 2 schemes and one initiative under the SEBI Act and the Depositories Act for registration and regulation of all market intermediaries, and for prevention of unfair trade practices, insider trading, etc. Under these Acts, Government and SEBI issue notifications, guidelines, and circulars which need to be complied with by the market participants. The institutions like exchanges and depositories have framed rules, byelaws, regulations to govern their operations and the operations of their constituents. The regulator and the exchanges have developed listing agreements to be complied with by the listed companies. Various regulations prescribe model agreements to be entered among the participants such as broker, sub-broker and client, depository and depository participant to govern their relations and their respective rights and obligations.

All the intermediaries in the securities market are now registered and regulated by SEBI. Before authorizing a person to act as an intermediary, the regulator determines if he is a fit and proper person to participate in the market. In order to do so, it takes account of financial integrity, convictions or civil liabilities, competence, reputation and character, efficiency and honesty, etc. A code of conduct has been prescribed for each intermediary as well as for their employees in the regulations; capital adequacy and other norms have been specified; a system of monitoring and inspecting their operations has been instituted to enforce compliance; and disciplinary actions are being taken against them for violating any regulation. All the intermediaries in the market are mandated to have a compliance officer who reports independently to SEBI about any non-compliance observed by him. The regulations also stipulate the human resource requirement for various activities to ensure quality intermediation services. These are the standard features of regulations relating to intermediaries all over the world.

The regulations have certain objectives. For example, registration requirements of participants ensure that only the authorized and capable persons transact in the market. Disclosure of data relevant to firms' financial prospects and standardized accounting practices ensure that information is available to participants to enable them to take informed decisions. Prohibition of insider trading and fraudulent/ manipulative / unfair trade practices prevents insiders / manipulators from profiting at the expense of non-insiders / ordinary investors. Takeover regulations protect minority shareholders. Investment management rules reduce scope for abuse by investment managers. The Indian securities market has effective regulations to achieve all these objectives.

Unlike securities laws, there is a set of benchmarks for securities regulations. The 30 Principles of Securities Regulation, released in February 2002 by IOSCO, is a standard yardstick against which progress towards effective regulation can be measured. IOSCO members, including SEBI, through their endorsement to these principles, intend to use their best endeavours to ensure adherence to these principles within their jurisdictions. The extent of compliance of the Indian securities market regulations with these principles is presented in the Table 1, a perusal of which indicates that India has substantially complied with all the 30 principles.

Table 1

Compliance with the IOSCO Principles of Securities Regulation

A. Principles relating to the Regulator

P1-5: The responsibilities of the regulator should be clear and objectively stated. It should be operationally independent and accountable in the exercise of its functions and powers. It should have adequate powers, proper resources and the capacity to perform its function and exercise its powers. It should adopt clear and consistent regulatory processes. Its staff should observe the highest professional standards, including appropriate standards of confidentiality.

S : The SEBI Act, 1992 has established SEBI and clothed it with responsibilities to protect the interests of investors and to promote the development of, and to regulate, the securities market. SEBI administers the Depositories Act, 1996. It also exercises powers relating to securities market under SCRA and the Companies Act, 1956 concurrently with central government. The division of responsibility among SEBI, RBI, DEA and DCA has been clearly spelt out in the Acts. SEBI has been vested with the authority to discipline the market participants and develop the market without any recourse to the government. The Government can issue directions to SEBI only in the matters of policy and can supercede it only in cases of grave emergencies or in public interest. The regulations framed by SEBI and its annual report providing an account of its activities, policies and programmes are laid before the Parliament. It jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with the securities market. It has powers of licensing, supervision, inspection, investigation and enforcement and to issue directions, impose monetary penalty, suspend/cancel certificates of registration, launch prosecution etc. It has instituted a consultative process before framing regulations. It has framed regulations to regulate the conduct of all kinds of intermediaries and for the orderly development of the market. The rules, regulations, guidelines, circulars etc. are put on the SEBI website for easy public access. The regulations framed by SEBI are published in the Gazette of India and also laid before each House of the Parliament. The Parliamentary Committee on Subordinate Legislation reviews them. All orders passed by SEBI are passed following principles of natural justice and are subject to review by the SAT. The Right to Information Act applies to SEBI. A code of conduct has been specified in the service regulations of SEBI. The staff are prohibited from investing in equity and equity related instruments and speculating in securities / commodities. They are also required to undertake and declare fidelity and secrecy.

B. Principles of Self-Regulation

P6-7: The regulatory regime should make appropriate use of self-regulatory organisations (SROs). They should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality.

S : SEBI is mandated to promote and regulate SROs. It has framed SRO Regulations for this purpose. However, these have not developed appreciably. The only SROs - exchanges - are under the direct oversight of SEBI. They make byelaws, rules and regulations for regulating the conduct of their members and contracts in securities. SEBI approves and amends the rules of exchanges and inspects them to ensure that the rules are adhered to.

C. Principles for the Enforcement of Securities Regulation

P8-10 : The regulator should have comprehensive inspection, investigation and surveillance powers. It should have comprehensive enforcement powers, including regulatory and investigative powers. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers.

S : SEBI has powers to require the provision of information, or to carry out inspections to ensure compliance with the prescribed standards. It can call for information and record from any authority, including statutory authorities, in respect of transactions in securities under investigation, and conduct inspection of any intermediary, person associated with securities market and listed company. While calling for information, it has the powers of a civil court in respect of discovery and production of records, summoning and enforcing attendance of persons and inspection of books / documents. It has powers of inspection, investigation and enforcement and to issue directions, impose monetary penalty, suspend/cancel certificates of registration, launch prosecution, etc. It can appoint an investigating authority to investigate the affairs of an intermediary or persons associated with the securities market. The investigating authority has vast powers, including power to call for information, power of search and seizure etc. It has established an effective and credible system of investigation, surveillance and enforcement.

D. Principles for Co-operation in Regulation

P11-13 : The regulator should have authority to share both public and non-public information with domestic and foreign counterparts. It should establish information sharing mechanisms with their domestic and foreign counterparts. The regulatory system should allow assistance to foreign regulators who need to make inquiries in the discharge of their functions.

S : There is no specific provision in law which enables SEBI to share public and non-public information. Nor is there any provision prohibiting it from entering into MOU with other regulatory authorities. However, SEBI has informal arrangements with DEA, DCA and RBI for sharing information. It has also arrangement to share information with securities market regulators of other countries.

E. Principles for Issuers

P14-16 : There should be full, timely and accurate disclosure of financial results and other information which is material to investors' decisions. Holders of securities in a company should be treated in a fair and equitable manner. Accounting and auditing standards should be of a high and internationally acceptable quality.

S : The Companies Act, SEBI DIP Guidelines and the listing agreement of the exchanges require the issuers to make full, timely and accurate disclosure of material facts to enable investors to make informed decisions. Disclosure extends to any material information having a bearing on the price of the security, people who have significant interests in or who seek control of the company, etc. The listing agreement requires all listed companies to publish on an annual basis financial statements audited by an external auditor and unaudited quarterly results. They also make disclosures in the annual reports in compliance with the Accounting Standard on "Related Party Disclosures". SEBI has set up an Electronic Data Information Filing and Retrieval System to facilitate an electronic filing of certain information by listed companies and their public dissemination. Financial statements are prepared and audited in accordance with the provisions of the Companies Act, 1956. SEBI Takeover Code, the Companies Act, the buyback and delisting regulations contain provisions for protection of minority shareholders.

F. Principles for Collective Investment Schemes

P17-20 : The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a CIS. It should provide for rules governing the legal form and structure of CIS and the segregation and protection of client assets. It should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a CIS for a particular investor. It should ensure that there is a proper and disclosed basis for assets valuation and the pricing and the redemption of units in a CIS.

S : Eligibility criteria in terms of net worth, track record, internal management procedure have been specified in Regulations for Mutual Funds, CIS and Venture Capital Funds. The regulations provide for registration and authorisation of scheme, inspection to ensure compliance, investigations and remedial action. Structure of

CIS has been specified in respective regulations. Disclosure standards, including format of offer document, have been specified in the respective regulations to provide investors with sufficient information to know if the scheme is an appropriate investment vehicle for him. Specific provisions have been made in the respective regulations for asset valuation and pricing of units. For example, applicable load as a percentage of NAV is added to NAV to calculate sale price and is subtracted from NAV to calculate repurchase price.

G. Principles for Market Intermediaries

P21-24 : The licensing process should require a comprehensive assessment of the applicant and the licensing authority should have power to withdraw or suspend the license. There should be initial and on going capital and prudential requirements for intermediaries that reflect the risks that the intermediaries undertake. Intermediaries should be required to comply with standards for internal organisations and operational conduct that aim to protect the interest of clients, ensure proper management risk, etc. There should be a procedure for dealing with the failure of a market intermediary.

S : An entity intending to act as an intermediary is required to have a registration / license to do so. The registration process checks the credentials and capability of the entities and persons associated with them and grants registration, only if found eligible and suitable. There is an established procedure provided in the regulations for granting the license to the intermediaries as well as its revocation. The entry norms for the intermediaries contain the capital adequacy clause as well as the maintenance of the same on a continuing basis. The intermediaries are required to frame a code on internal procedure and conduct. They also abide by the Code for Corporate Disclosure Practices specified in the regulations. Regulations for intermediaries specify a code of conduct, which contains provisions to protect the interests of the clients and ensure proper management of risk. There are arrangements like Settlement/Trade Guarantee Funds and the Investor Protection Funds for dealing with the failure of market intermediaries.

H. Principles for Secondary Market

P25-30 : The establishment of trading systems including securities exchanges should be subject to regulatory authorisation and oversight. There should be ongoing regulatory supervision of exchanges. Regulation should promote transparency of trading and detect and deter manipulation and other unfair trading practices. It should aim to ensure the proper management of large exposures, default risk and market disruption. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight.

S : The trading systems (stock exchanges) are regulated by a process of recognition and continued supervision under the SCRA. Fair and equitable rules have been framed by stock exchanges, SEBI and Government under the SCRA and SEBI Act for supervision of trading system and stock exchanges. Approval of the trading system may be withdrawn by the regulator when it is determined that the system is unable to comply with the conditions of approval or with laws/regulations. All trades are executed only through on-line automated price and order matching mechanism of stock exchanges. It enables the market participants to see the full market on a real time basis, making the market transparent. The information relating to trading is available to the public on a real time basis. Regulations have been framed to prevent insider trading, and fraudulent and unfair trade practices. These have been expressly prohibited under the SEBI Act and penalties for such offences extend up to Rs. 25 crore or three times the illegal profits made whichever is higher. Limits have been specified on turnover and exposure in relation to the base minimum capital which a member keeps with exchange. The exposure of members is monitored on a real time basis. Members breaching the limits are automatically and instantaneously disabled by the trading system. The SSS, under the oversight of regulator, guarantees settlement of net obligations of the members.

P : Principle, S: Status of Compliance

MARKET DESIGN

In order to improve the quality of the market, that is, to improve market efficiency, enhance transparency, prevent unfair trade practices and raise the Indian market to international standards, the market is being redesigned continuously. The practice of allocation of resources among different competing entities as well as its terms by a central authority was discontinued. The issuers complying with the eligibility criteria were allowed the freedom to issue the securities at market-determined rates. The market shifted formally and completely from merit based regulation to disclosure-based regulation. The secondary market overcame the geographical barriers by moving to screen based trading. The trading system is now accessed through 10,000 trading terminals spread across more than 400 cities / towns in the Indian sub-continent and also through the internet and hand held mobile devices from all over the world. All kinds of securities – debt and equity, government and corporate – are traded on the exchanges side by side. As a result of these redesigns, the market design has changed drastically, and is now at par with, or even better in some respects than, the best jurisdictions, as may be seen from Table 2.

Table 2

Elements of Market Design in Indian Securities Market, 1992 and 2005

Features	*1992*	*2005*
	Corporate Securities Market	
Regulator	No specific regulator, but Central Government oversight	A specialized regulator for securities market (SEBI) vested with the powers to protect investors' interest and to develop and regulate securities market. SROs strengthened
Securities	Limited number of traditional instruments	Expanded to cover government securities, units of CISs and MFs, derivatives of securities, security receipts, etc.
Form of Securities	Physical	Dematerialised
Regulatory Approach	Merit based regulation	Disclosure based regulation
Intermediaries	Some of the intermediaries(stock brokers, authorized clerks and remisiers) regulated by the SROs	A variety of specialized intermediaries emerged. They are registered and regulated by SEBI (also by SROs in some instances). They as well as their employees are required to follow a code of conduct and are subject to a number of compliances. All participants are identified by a unique identification number
Access to Market	Granted by the Central Government	Eligible issuers access the market after complying with the issue requirements
Disclosure	Voluntary, vague, scanty and non-standardised	Standardised, systematic and at par with the international standards. A dedicated web site for corporate disclosures, EDIFAR, operationalised
Pricing of Securities	Determined by the Central Government	Determined by market, either by the issuer through fixed price or by the investors through book building
Access to International Market	No access	Corporates allowed to issue ADRs/ GDRs and raise ECBs. ADRs/GDRs have two way fungibilty. FIIs allowed to trade in Indian market. MFs also allowed to invest overseas
Corporate Compliance	Very little emphasis	Emphasis on disclosures, accounting standards and corporate governance
Mutual Funds	Restricted to public sector	Open to private sector and emergence of a variety of funds and schemes
Exchange Structure	Mutual not-for-profit exchanges	For profit corporate, demutualised exchanges

Trading Mechanism	Open outcry, available at the trading rings of the exchanges; opaque, auction/negotiated deals	Screen based trading system; orders are matched on price-time priority; transparent, trading platform accessible from all over the country
Aggregation of Order Flow	Market fragmented by geographical distance.	Order flow unobserved. Order flow observed. The exchanges have open electronic consolidated limit order book (OECLOB)
Anonymity in Trading	Absent	Complete
Settlement Cycle	14-days account period settlement, not adhered to always	Rolling settlement on T+2 basis
Counter-party Risk	Present	Absent
Form of Settlement	Physical	Mostly electronic
Basis of Settlement	Bilateral netting	Multilateral netting
Transfer of Securities	Cumbersome. Transfer by endorsement on security and registration by issuer	Securities are freely transferable. Transfers are recorded electronically in book entry form by depositories.
Risk Management	No focus on risk management	Comprehensive risk management system encompassing capital adequacy, limits on exposure and turnover, VaR based margining, client level gross margining, on-line position monitoring, business continuity plans, etc.
Derivatives Trading	Absent	A wide array of exchange traded derivatives such as Futures and Options on indices and select securities and Futures on interest rate available
Research	Very little	Many market participants have full fledged research departments. Some of them have schemes / initiatives to promote research
	Government Securities Market	
Securities	Plain vanilla securities	Expanded to include zero coupon bonds, floating rate bonds, capital indexed bonds, bonds with embedded derivatives, interest rate futures, etc.
Form of Securities	Physical	Demat holding by RBI regulated entities
Pricing of Securities	Administered interest rates	Issue at market related rates (auction)
Participation	Captive investors (mostly banks)	Expanded to allow primary dealers, FIIs, retail investors
Trading Mechanism	Through telephone	Negotiated Dealing System which provides negotiation and screen based trading
Counterparty Risk	Present	Clearing Corporation provides novation and guarantees settlement
Mode of Settlement		Delivery-versus-payment (DVP-III)

There are three sets of global benchmarks in the area of SSS. There are: ISSA Recommendations 2000, BIS-IOSCO Recommendations 2001, and G30 Recommendations 2003. ISSA Recommendations 2000 recommend standards for governance of SSS, technology, technical standards, market practices, settlement risk, market linkages, investor protection and legal infrastructure. BIS – IOSCO Recommendation 2001 prescribe standards for legal risk, pre-settlement risk, settlement risk, operational risk and other issues relating to SSS. G30 Recommendations 2003 require comparison of trade between direct market participants by T+0, an effective and fully developed central securities depository, a trade netting system, a DvP system, "same day" funds convention for payments, T+3 rolling settlement, securities lending and borrowing mechanism, adoption of ISO standard for securities messages and the ISIN numbering system for securities transactions.

In Indian securities market, the trades accumulate over the trading cycle of one day and at the end of the day, these are clubbed together, and positions are netted and payment of cash and delivery of securities settle the balance two working days after the trading day. Trades are executed on screen and matched trade details are linked to settlement system electronically, and hence matching and confirmation of trades for direct participants are instantaneous. All communications relating to securities settlement are fully electronic and automated. For instance, the clearing agency uploads the obligations and pay-in advices of funds / securities to members electronically through secured networks. It also sends electronic advice to clearing banks and depositories to debit the members' accounts to the extent of their obligations. The banks and the depositories debit accounts of members and credit the account of the clearing agency electronically. The reverse happens when the funds / securities are paid out to members. The exchange is connected electronically to the clearing and settlement agency, which in turn is connected electronically to clearing banks, depositories, custodians and members. The depositories have electronic communication with depository participants, clearing agency, custodians, clients and exchanges. Most of these electronic communications are interactive. To pre-empt market failures and protect investors, the regulator/exchanges have developed a comprehensive risk management system, which is constantly monitored and upgraded. It encompasses capital adequacy requirements for members, adequate margin requirements, limits on exposure and turnover, indemnity insurance, on-line position monitoring and automatic disablement, etc. They also operate an efficient market surveillance system to detect excessive volatility and prevent price manipulations. Exchanges have set up trade/settlement guarantee funds for meeting shortages in a settlement arising out of non-fulfillment/partial fulfillment of funds obligations by the members. A clearing corporation assumes the counterparty risk of each member and guarantees financial settlement.

The Indian SSS architecture encompasses the use of the state-of-the-art information technology in the SSS, T+2 rolling settlement, securities lending and borrowing, professionalisation of trading members, fine-tuned risk management system, clearing corporation to assume counterparty risk, real time gross settlement / electronic fund transfer facility, straight through processing, 100% electronic trading which obviates the need for trade confirmation, finality of settlement from the moment the trade is executed, delivery versus payment, dematerialisation and electronic transfer of securities, 100% settlement in demat form, etc. and complies with the international standards such as ISSA Recommendations 2000, CPSS-IOSCO Recommendations 2001, and G30 Recommendations 2003 in letter and spirit. In many respects, Indian SSS is ahead of many developed markets.

One yardstick used internationally to measure the extent of improvement in the SSS is the GSCS Benchmarks. These Benchmarks assess the settlement efficiency in the form of a single number expressed as a score out of 100 and provide an indication of the aggregate level of post-trade operational efficiency in the securities market and track the evolution of the settlement performance over time. The higher the score, the higher is the efficiency. These Benchmarks comprise of Settlement Benchmark, Safekeeping Benchmark and Operational Risk Benchmark. Over the last 10 years, the settlement benchmark improved from –16.8 in 1995 to 93.1 in 2004, as presented in the Table No. 3.

Table 3

GSCS Benchmarks on Settlement Efficiency

Benchmark	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Settlement	-16.8	-0.7	-1.2	10.0	41.9	59.6	75.8	87.7	93.6	93.1
Safekeeping	75.0	76.6	76.8	69.7	78.1	81.9	86.7	88.6	88.1	91.8
Operational Risk	0.0	16.8	23.5	47.3	43.6	51.4	59.1	64.1	66.0	67.2

Source : Various Issues of Review of Emerging Markets, GSCS Benchmarks.

MARKET OUTCOME

The proof of the pudding lies in eating. The impact of laws, regulations and market design is ultimately reflected in the market outcomes such as amount of capital raised, the depth of the market, liquidity and volatility, cost of transactions, etc. However, comparative data in respect of different parameters of the outcome are not easily available. The comparable data are available only in respect of transactions in the secondary market, albeit with severe limitations. For example, the number of listed companies in India is 4730, as presented in Table 5, while the actual number is about 10,000. This is so because the data compilation agency has collected data only from one exchange in India. The data presented in Table 4, 5 and 6, therefore, underestimate the different parameters in respect of the Indian securities market. Despite this limitation, India ranks second in terms of the number of listed companies. The number of companies listed in many markets is much less than the number of companies traded daily on the Indian exchanges.

Table 4

International Comparison of Secondary Cash Market (End December 2004)

Particulars	*India*	*USA*	*UK*	*Japan*	*Malaysia*	*Thailand*	*Singapore*	*China*
Number of Listed Companies	4730	5231	2486	3220	962	465	489	1384
Ranking in terms of Listed Companies	2	1	7	6	12	20	19	10
Ranking in terms of Company Size	70	4	16	15	51	47	37	32
MC (US $ Billion)	387.85	16323.73	2815.93	3678.26	190.01	115.40	171.56	639.77
Ranking in terms of MC	18	1	3	2	23	31	26	13
MC Ratio (%)	56.06	139.91	131.53	79.56	161.33	70.58	160.60	38.79
Share in World MC (%)	1.00	41.96	7.24	9.45	0.57	0.30	0.44	1.64
Market Weight in the World Index (%)	6.90	52.80	10.50	9.60	3.10	2.70	0.40	9.80
World Index Stocks' Share of MC (%)	73.70	95.60	95.90	86.40	75.10	84.10	94.60	66.60
10 Largest Index Stocks' Share in MC (%)	33.40	14.70	40.90	18.20	34.20	44.90	34.20	28.90
Turnover (US $ Billion)	379.09	19354.90	3707.19	3430.42	59.88	109.95	81.31	748.27
Ranking in terms of Turnover	18	1	2	3	30	24	27	8
Turnover Ratio (%)	115.50	126.50	142.20	105.10	33.40	95.80	52.20	113.30
Ranking in terms of Turnover Ratio	15	9	8	18	41	19	32	16
Share in World Turnover (%)	0.96	49.24	9.43	8.73	0.15	0.28	0.21	1.90
World Index Stocks' Share of Turnover (%)	75.10	NA	NA	NA	49.30	70.50	NA	47.40
10 Most Active Index Stocks' Share in Turnover (%)	42.60	NA	NA	NA	23.90	32.30	NA	13.70
Trading Cost, including Impact Cost (BP)	66.91	32.41	51.60	19.80	55.86	54.05	37.98	NA
Index Return (%)	23.7	9.0	15.3	15.2	14.3	-11.8	21.8	-15.4
Ranking in terms of Return	64	91	82	84	85	99	67	100
Price - Earning Ratio	18.08	22.35	23.80	29.17	22.35	12.78	16.83	19.12
Blue Chips Index Volatility (%)	1.6	NA	9.8	48.4	NA	27.8	NA	1.2

MC : Market Capitalisation

Source : World Development Indicators 2005, Global Stock Markets Fact Book 2005, and World Federation of Exchanges.

It may be noted that Table 4 and 5 present data in respect of India vis-à-vis the developed securities markets and India's position in the comity of markets. The market capitalization, which has been growing at an annual compound growth rate of 13% over 1996-2005, is comparable in absolute as well as relative terms to any other emerging market and many a developed market. As a ratio of GDP, it worked out to 46.5% in 2003. This ratio surpassed that of middle-income markets. Indian securities market was the 18th largest market in terms of market capitalisation as at end December 2004, accounting for 8.2% of the market capitalization of emerging markets and 1% of the world market capitalization as against 6.38% and 0.41% respectively in 1990. The constituent shares from the Indian securities market, which has a weightage of 6.9% (up from 5.3% in 1995) in the S&P/IFCG Index of Emerging Stock Markets, accounted for 73.7% of the market capitalization. The ten largest index stocks accounted for only 33.4% of the market capitalization.

Table 5

Market Capitalisation and Turnover for Major Markets

(In US $ million)

Country/Region	*Market Capitalisation (End of Period)*			*Turnover (12 Months Cumulative)*		
	1990	*1995*	*2004*	*1990*	*1995*	*2004*
All Developed Markets	**8795239**	**15880109**	**34173600**	**4616473**	**9180132**	**35341782**
Australia	108879	245218	776403	40113	98654	514249
Japan	2917679	3667292	3678262	1602388	1231552	3430420
United Kingdom	848866	1407737	2815928	278740	510131	3707191
United States of America	3059434	6857622	16323726	1751252	5108591	19354899
All Emerging Markets	**604420**	**1893234**	**4730418**	**898233**	**1040192**	**3967806**
China	2030	42055	639765	-	49774	748274
India	**38567**	**127199**	**387851**	**21918**	**21962**	**379085**
Indonesia	8081	66585	73251	3992	14403	27561
Korea	110594	181955	428649	75949	185197	638891
Malaysia	48611	190011	222729	10871	76822	59878
Philippines	5927	58930	28948	1216	14727	3664
Taiwan	100710	187206	441436	715005	383099	718619
World Total	**9399659**	**17773343**	**38904018**	**5514706**	**10220324**	**39309589**
Developed Markets as a % of World	93.57	89.35	87.84	83.71	89.82	89.91
Emerging Markets as a % of World	6.43	10.65	12.16	16.29	10.18	10.09
USA as a % of World	32.55	38.58	41.96	31.76	49.98	49.24
India as a % of Emerging Markets	**6.38**	**6.72**	**8.20**	**2.44**	**2.11**	**9.55**
India as a % of World	**0.41**	**0.72**	**1.00**	**0.40**	**0.21**	**0.96**

Source : Global Stock Markets Fact Book 2005.

The turnover in the cash segment of the Indian securities market has been increasing at an annual compound growth rate of 22% over 1996-2005. It ranked 18th among the securities markets in terms of turnover and 15th in terms of turnover ratio during 2004 with a turnover ratio of 115.5% as against 65.9% in 1990. The turnover ratio is not only higher than the world average, but also higher than that of the high-income markets. It accounted for 0.96% of world turnover and 9.6% of emerging markets turnover in 2004 as against 0.21% and 2.11% in 1995. The ten largest index stocks accounted for only 42.6% of total turnover. In terms of number of transactions, NSE and BSE are the 3rd and 5th largest exchange respectively in the world.

Table 6

Breadth and Depth of Secondary Securities Markets

Markets	*Market Capitalisation (% of GDP)*		*Turnover Ratio (% of MC)*		*Listed Domestic Companies*	
	1990	*2003*	*1990*	*2004*	*1990*	*2004*
High Income	**51.6**	**100.1**	**59.4**	**110.1**	**17,733**	**27,594**
Middle Income	**19.4**	**44.5**	**....**	**60.9**	**4,370**	**14,456**
Low & Middle Income	**18.8**	**43.5**	**....**	**72.4**	**7,691**	**22,444**
East Asia & Pacific	16.4	53.5	118.1	103.5	774	3,582
Europe and Central Asia	2.2	29.7	....	37.9	110	7,776
Latin America & Caribbean	7.7	33.2	29.8	22.0	1,748	1,468
Middle East & N. Africa	27.4	47.3	....	64.4	817	1,803
South Asia	10.8	39.8	54.0	131.2	3,231	6,909
Sub-Sahara Africa	52.3	105.9	....	39.3	1,011	906
Low Income	**10.5**	**37.3**	**48.2**	**130.5**	**3,321**	**7,988**
India	**12.2**	**46.5**	**65.9**	**115.5**	**2,435**	**4,730**
World	**48.0**	**89.7**	**57.2**	**72.4**	**25,424**	**50,038**

Source : World Development Indicators 2005

The Indian securities market is quite attractive in terms of cost of transactions, returns and volatility. The trading costs for institutions were 66.91 basis points during 2004. The index return was not only the highest among all the markets considered; it was one of the least volatile. It is not surprising that India accounts for almost half of the net inward portfolio equity flows to all developing economies. The last two years have witnessed FII inflows of US$ 10 billion each. Their holding constitutes about 15% of market capitalization.

REMAINING AREAS

There is no substantive area, where Indian securities laws and markets do not have global standards. This section, however, makes a few suggestions in the peripheral areas to bring Indian securities laws and markets to the global standards.

A. Securities Laws

(i) There are several statutes regulating different aspects of the securities market. The four main legislations are: the SEBI Act, 1992, the Companies Act, 1956, the SCRA, 1956, and the Depositories Act, 1996. The larger the number of laws, the higher is the scope for inconsistency among them and the possibility of regulatory overlaps and gaps. There are also as many regulators as the number of laws. The larger the number of regulators, the higher is the scope for confusion among the regulators and the regulated and duplicacy and inconsistency in regulations. Besides, there is no statutory provision to provide for regulatory cooperation / sharing information among the domestic regulators and between overseas and domestic regulators. Powers of the regulator to assist / seek assistance from overseas regulators or to enter into

MOUs or other co-operation arrangements with them to deal with cross border misconduct are not explicitly provided in any legislation, though these are also not forbidden. The protection of the interests of investors requires consolidation of all laws relating to securities market into a single piece of legislation, preferably called the Securities Act which should prevail over the general laws. The administration of the Act may be assigned to one agency with clearly defined regulatory jurisdiction and accountability. And the agency must work in close coordination with other regulators, domestic or foreign.

(ii) Most of the enforcement actions of Securities Exchange Commission (SEC), US are resolved by settlement with defendants (accused), who generally consent to the entry of judicial or administrative orders without admitting or denying the allegations against them. These orders usually require the defendants to agree to be censured, to a cease and desist order, to be barred from appearing/practising/dealing in a certain manner / before an authority, to a permanent injunction, to pay a civil monetary penalty, to the disgorgement of illegal gains or illegally avoided losses, or to comply with numerous other undertakings. The SEC lets off the accused who simply pay up without admitting to an offence. This prevents every case being locked up in a court. Given the number of cases pending in the Indian courts and intangible nature of securities market offences, SEBI requires similar facilities if the offenders are to be punished on priority. This would help to bring all the co-accused to book or solve difficult cases if one accused provides lead by agreeing to plea bargain in exchange of a lenient sentence.

(iii) The SEBI Act provides for two alternative types of punishment. They are: (a) suspension or cancellation of certificates of registration to be imposed by SEBI on the recommendation of an enquiry officer, or (b) monetary penalty to be imposed by an adjudicating officer. These two types of punishments are mutually exclusive. If a contravention is assigned to an adjudicating officer for adjudication, it cannot be referred to enquiry officer and vice-versa. A corollary of this is that mind is made up about the type of punishment (not quantity of punishment) to be imposed on the erring party when the alleged contravention is referred to an adjudicating officer for adjudication or to an enquiry officer for imposition of suspension or cancellation of registration, that is, at a stage when the nature and gravity of the contravention has not been fully ascertained. If a contravention is assigned to an enquiry officer, monetary penalty cannot be imposed even if the enquiry findings justify monetary penalty. Similarly if a contravention is assigned to an adjudication officer, the registration cannot be cancelled even if the adjudicating officer comes to the conclusion that the contravention warrants cancellation of registration. It would, therefore, be desirable to allow adjudicating officers to try all contraventions under the SEBI Act, rather all securities laws, and award all types of penalties so that SEBI can concentrate on developmental and regulatory work.

(iv) The regulator must not be an interested party. It must not have any interest other than the protection of interests of investors and orderly development of the market. This principle is not followed in case of government securities. RBI, which is the manager of the monetary policy, acts as the regulator for government securities market, and also participates in the market simultaneously as the manager of government debt, issuer of securities, merchant banker to issue, registrar and transfer agent, clearing and settlement agent, depository for securities, provider of trading platform, and subscriber to securities. In such cases, it may not always be possible to avoid conflict of interests. The decisions relating to debt management, interest rate and regulation of market should be taken independently to avoid perceived conflict of interests.

(v) The intermediaries hold in their custody, and handle, the money and the securities on behalf of clients. However, there is an apprehension that the assets of the clients can be attached in case of insolvency of the intermediaries or can be misused by them. In order to dispel this apprehension, it is necessary to provide in law that an investor can entrust the money or securities to any intermediary who shall hold such assets in trust and shall not have any right, title or interest of any nature therein. He shall deal with such assets as directed by the investor and shall be accountable for the same. Such assets shall not form part of assets of the intermediary and no authority can attach or seize such assets.

(vi) It is not enough that the culprit is punished. The culprit needs to be punished in an exemplary manner, while investor should have means to recover his loss caused by the culprit. The law should empower the authorities not only to levy penalties, but also award compensation to investor and enforce disgorgement of illegal gains made by the accused. A group insurance policy may be considered under which an investor, losing any money for whatever reason except for market loss or his own negligence and not compensated by the negligent or defrauding party, is compensated upto a specified amount. In the US, an organisation called Securities Investor Protection Corporation under the Securities Investor Protection Act, 1970, operates a similar insurance mechanism to compensate up to US $ 5,00,000 per investor in securities.

B. Securities Regulations

(i) Many investors, particularly small ones, do not have expertise on their own to make investment decisions. They depend on the advice from others who may not be competent to render such advice and be accountable for the same. All kinds of people, irrespective of their competence, sell financial products to, and advise, the investors on various products. This is as dangerous as a quack providing medical treatment. SEBI Act empowers SEBI to register and regulate investment advisors in securities. While SEBI may frame regulations for investment advisers in securities, it may be desirable to lay down a set of comprehensive regulations to groom and govern the profession of Financial Planners / Investment Advisers across the financial market. This is akin to the provisions in the Investment Advisers Act, 1940 in the US.

(ii) The SROs are expected to share the responsibility with the regulator in framing as well as administering regulations. However, the SROs have not developed appreciably in India, even though SEBI has framed regulations for regulation of SROs. Most of the associations of intermediaries like, AMFI, AMBI do not exactly regulate, though they promote the activities of their members. It may be desirable to mandate SROs for all kinds of market participants.

(iii) While formulating regulations, no conscious effort is made to estimate the cost of regulation and to verify if the benefits from regulation outweigh the costs of regulation. In order to prevent overregulation, it is necessary that the regulators explicitly take into account the costs of regulation. Further, there is no provision in the law requiring the regulator to consult the regulated while formulating regulations. SEBI has, however, instituted a consultative process before framing regulations. A statutory obligation may be cast on the regulator to consult the regulated, as this improves quality of regulation and ensures its smooth implementation.

(iv) In developed markets and in some of the developing markets, quality of intermediation services is ensured through a system of testing and certification of persons working with market intermediaries in the securities market. In the US, for example, any securities professional associated with a member firm, including partners, officers, directors, branch managers, department supervisors, and salespersons, is required to register with the NASD. As part of the registration process, securities professionals must pass an examination administered by the NASD Regulation to demonstrate their competence in the areas in which they will work. This sort of arrangement ensures that a person dealing with financial products has a minimum standard of knowledge about them, market and regulations so as to assist the customers in their dealings, and bars ill-equipped personnel from providing intermediation services in the securities market. The SEBI regulations require such certification in case of mutual fund distributors and derivative dealers. Regulations of exchanges and depositories require such certification for their constituents. This needs to be extended to all persons working with or as market intermediaries.

(v) A significant challenge to the regulators across the globe is the convergences of the opportunity zones. Traditionally, businesses were clearly differentiated; banks offered banking, insurance companies offered risk covers and securities companies offered services related to investments. This resulted in separation of supervisory structures along business lines. The economies of scale and economies of scope are, however, driving the emergence of financial power houses which are one stop shops for all financial products / services. This has the danger of risk of one activity / segment spilling over to the other activities / segments of the markets. If there are different regulators for different activities, there is a potential problem of shifting responsibilities among the regulators, particularly at times of crisis. The regulators, domestic and overseas, need to co-operate more frequently than ever before, and that too at multiple levels. This can be accomplished either through effective co-ordination among the regulators or by the creation of a single regulatory body. Some economies are choosing the first option and some the second. India has to choose a course and move forward fast.

(vii) There should be a procedure for dealing with failure, closure, or cancellation of registration of an intermediary in order to minimize loss to investors and to contain systemic risk. In respect many intermediaries, there is an arrangement to deal with failures. However, the consequences of voluntary surrender or penal cancellation of registration on the investors are not very clear. The order accepting surrender of registration or cancellation of registration may provide for certain consequential matters. For example, the intermediary may be allowed a period of moratorium to enable it to wind up the business and the investors to make alternative arrangements. In respect of depository participants, brokers and sub-brokers, the responsibility to oversee winding up of business and shifting of customers to another intermediary may be assigned to depositories or exchanges concerned, as the case may be. In other cases, the regulations may provide for an administrator to do so. In all such cases, the claim of the clients of the intermediary should have priority over other claims or debts. The regulator may be empowered to file a winding up petition against an intermediary in case such intermediary goes bankrupt or the continuance of such intermediary is considered detrimental to the interests of investors or market.

(vii) In order to enable the investor to choose the right intermediary through whom he may transact business, it may be useful to make details of the intermediaries available to him. The details may include the form of organization, management, capital adequacy, liabilities, defaults and penal actions taken by the regulator and self-regulatory organizations against the intermediary in the past and other relevant information. The intermediary may be mandated to make continuous disclosures about its performance and financial positions through a web site such as the EDIFAR. The intermediaries may not be allowed to outsource their activities unless they comply with the IOSCO standards of outsourcing. The Regulations may prescribe the governance standards for the intermediaries.

C. Market Design

(i) The trades executed on exchanges are settled through clearing corporation. The law has been amended recently to provide that an exchange may, with the approval of SEBI, transfer the duties and functions of a clearing house to a recognized clearing corporation. The rules relating to governance of clearing corporations need to be framed and the clearing corporations need to be recognized. All exchanges need to be mandated to settle trades through a clearing corporation. STP needs to be extended to cover all the market participants. All participants need to be identified by global identification methodology. They need to follow internationally compatible messaging standards.

(ii) The optimum utilization of resources dictates that a member / client is allowed to take an aggregate position across products / market segments / exchanges as long as he does not exceed the permitted aggregate exposure. The clearing agency should compute and levy a single net margin amount after netting the positions of a member / client in different products / segments / exchanges.

(iii) The market for securities lending and borrowing allows the participants to sell the securities that they do not own and to obtain finance through the lending of securities against cash. This enhances liquidity, which leads to reduced cost of trading, thereby facilitating more efficient settlement, tighter dealer spreads and a reduction in the cost of capital. With an active securities lending and borrowing market in place, the market can even do away with auctions and the derivatives can be settled by actual delivery of securities. This market needs to be promoted and all obstacles in the way need to be removed.

(iv) The Securities Exchange Act, 1934 provides specific power to SEC to regulate short sales of exchange listed securities. The regulations allow relatively unrestricted short selling in an advancing market while preventing short sellers from accelerating a declining market. The regulation uses tick-test, a formula for defining price for permissible as well as non-permissible short selling. Every short-sale transaction is disclosed upfront to the dealing broker who is held responsible for ensuring that the transaction does not violate the tick-test. It means that short selling cannot take place surreptitiously in the US market. All market participants may be allowed to sell short subject to regulations that may be framed by SEBI.

(v) The margin trading enables clients to trade more than their own resources would permit and hence increases supply of and demand for securities / funds in the market. It thus contributes to liquidity by making higher trading volumes possible than it would have been otherwise possible. It helps in better price discovery by supporting larger supply of and demand for funds / securities. Margin trading and trading of derivatives generally complement rolling settlement, where time for round about transaction is limited to a day. This is why markets having rolling settlement generally provide the facility of margin trading. Despite the enabling provisions, margin trading has not taken off. This calls for a review of the existing mechanism.

RESTRUCTURING PROFESSIONAL FIRMS FOR GATS REGIME

S THIRUMALAI*

1. BACKGOROUND : GATS

1.1 The General Agreement on Trade in Services has come into effect on 1st January 1995 as a result of Uruguay Round with the establishment of World Trade Organisation (WTO). This is a multilateral instrument and treated as a single undertaking. India is one of the signatories to all the WTO Agreements.

1.2 Before the Uruguay Round, it was considered that services did not possess as much potential as in the case of trade in goods. However, due to fast developments in transmission technologies, the transferability of services has shown a phenomenal growth. It has helped the increased flow of services between countries. The main purpose of the creation of the General Agreement on Trade in Services are:

(i) Credible and reliable system of international trade rules for service;

(ii) Ensuring fair and equitable treatment of all countries on the principles of non-discrimination;

(iii) Stimulating trade in services by seeking to create a predictable policy environment wherein member countries voluntarily undertake to follow policies relating to trade in services.

1.3 **Services Covered**: The General Agreement on Trade in Services covers the following services:

1. Business Services (including professional and computer services)
2. Communication Services.
3. Construction and Engineering Services.
4. Distribution Services.
5. Education Services.
6. Environment Services.
7. Finance Services
8. Health Services.
9. Tourism and Travel Services.
10. Recreation, Cultural and Sporting Services.
11. Transportation Services.
12. Other Services not elsewhere classified.

These 12 services are divided into 161 sub-categories of services.

1.4 **Mode of Supply of Service** : The General Agreement on Trade in Services are divided into four modes of supply of services and they are :

(i) *Cross Border Supply* : It refers to a situation where the service flows from the territory of one member country into the territory of another member country. For example, an architect can send

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his architectural plan through electronic means. In this case trade in service takes place and it is equivalent to cross border movement of goods.

(ii) *Consumption Abroad* : It refers to a situation where consumer of a service moves into the territory of another member country to obtain the service. For example, patients from U.S.A. or U.K. visit India to avail health care service in Chennai, Mumbai, Delhi etc.

(iii) *Commercial Presence*: It means that the supplier of service of a member country establishes a territorial presence in another member country with a view to providing services. For example, an Indian Bank opens a Branch in Singapore to provide banking service to the public of Singapore.

(iv) *Presence and Movement of Natural Persons* : It covers situations in which a service delivered through persons of a member country temporarily visiting the another member country and providing service there. For example, software engineers from India visiting U.S.A. and providing software service to a company there.

1.5 India is interested in Mode (iv) and Mode (i). Interest arises in Mode (iv) due to the presence of a large skilled and competitive work force in the country. On the other hand core competence in Information Technology enabled services will enable India to take advantage of cross border supply of services i.e. Mode (i).

1.6 **Market Access** : Among other commitments the market access is one of the important commitments given by member countries in specified sectors after negotiations. It can be given with one or two limitations such as number of service suppliers, service operators or employees in a sector, the value of transaction, the legal form of the service supplier etc.

1.6.1 It is expected that India will be giving market access on reciprocal basis to other member countries. It will have an impact on the professions such as Company Secretaries, Chartered Accountants and Cost and Works Accountants.

1.6.2 This will open up opportunities and create threats as well.

1.6.3 The Indian firms will be in a position to provide services in other countries. In the developed countries cost of service is very high and this offers scope for Indian professional firms to render professional services overseas.

1.6.4 Simultaneously professional firms in the developed countries will set shop in India and with the help of Indian professionals would attempt to penetrate into the Indian market.

2. COMPANY SECRETARIES

Current Position : The Company Secretaries profession can be divided into two main segments.

2.1 That segment who are in employment with companies. Their main roles are in the following areas:

(i) Corporate Governance.

(ii) Board meetings.

(iii) Legal compliance.

(iv) Bridge with other segments of the company.

(v) Investor Protection and Service.

(vi) Conducting meetings of share holders, debenture holders etc.

(vii) Appearing before various authorities.

(viii) CEO's conscience keeper.

2.2 The other segment is that of Practising Company Secretaries. The main roles of the Practicing Company Secretaries are:

(i) Certification.

(ii) Secretarial Compliance.

(iii) Secretarial Audit.

(iv) Representation before various authorities like Registrar of Companies, Company Law Board etc.

(v) Handling of Direct and Indirect Tax compliance, Tax planning etc.,

(vi) Consulting.

3. OPENING UP OF PROFESSIONAL SERVICES

3.1 The opening up of services will have significant impact on the profession. It will throw open opportunities. In the same manner it will create competition from developed countries.

3.2 The foreign professional firms will have certain advantages vis-a-vis the Indian firms. They are

(i) Brand Name.

(ii) System Oriented Approach and Access to International Practices.

(iii) Use of Information System and Technology.

(iv) Advantage of Scale.

4. OPPORTUNITIES

4.1 It is outsourcing time. Companies in the developed countries want to concentrate only on their core business and out source activities. Business Process Outsourcing is the mantra of the present period. Now Legal Outsourcing is growing rapidly. It is possible for Company Secretaries to enter this arena in a big way.

4.2 Business Process Outsourcing firms are talking about 'Value Added Services' instead of providing basic transaction processing service.

4.2.1 For example, BPO units can receive the particulars of transactions and complete the book keeping function and send information back to the receiver of the service. In other words the Indian BPO Unit will do the book-keeping work and receiver of the service will do all other activities such as preparation of Annual Financial Statements and Reports. Instead Indian BPO Unit could upgrade into US GAAP requirements, Company Law Requirements, Securities & Exchange Commission Requirements and provide 'end - to - end Value Added Service'. Qualified professionals like Company Secretaries would have ample opportunities. The remuneration would be commensurate with the time and investment required as these will be "Premium Jobs".

5. THREATS

Company Secretaries have to compete with foreign firms. If Indian professional firms have to compete with foreign firms some degree of restructuring may be called for.

5.1 Multi Disciplinary Approach: In order to enable the professionals to compete with International firms, the professional institutes should allow members to enter into partnership with other professionals. A move already put in whereby ICSI has to be hastened in the light of developments in the GATS led environment. For example Company Secretaries should be allowed to form partnership with Chartered Accountants, Cost Accountants, Lawyers, Engineers, Management Professionals in order to enable them to provide portfolio of services to clients under one umbrella.

5.2 Specialization : Small firms as well as individuals practicing Accountancy, Law, Company Secretaryship etc. are compelled to handle all aspects of practice of the profession in a general way. If these firms have to compete with international firms it is necessary that they should specialise. This does not refer to subject specialisation such as Company Law, Accounting Standards, U.S.GAAP, FEMA, Inbound investments, Outbound Investments, Merger and Acquisition, etc. but also refers to vertical specialisation i.e. Industry specialization such Banking Sector, Insurance Sector, Oil Sector, Logistic Sector, Power Sector, Health Care, Hospitality Sector etc.

5.3 Merger and Acquisition: Many of the professional firms may need to consider and take advantage of size in handling complexity. They should become "Learning Organisations" capable of flexibility in all work and learning on the job. As stated above foreign firms are large in size with more partners and hundreds of employees. If Indian firms have to meet the challenge, small firms should merge with other firms. Like wise medium sized firms can combine with the small firms in order to increase the size of the firm. It is necessary that our laws have to be amended to allow more than 20 partners in a firm.

5.4 Corporatisation : Like wise the Institute of Company Secretaries of India should allow it members to form companies to practise as Company Secretary and it will go a long way to strengthen the profession. These companies can be LLPs (Limited Liability Partnerships) in view of the statutory claims that are possible with international exposure.

5.5 Collaboration with Foreign Professional Firms : The professional institutes should allow local firms network with professional firms in other countries. This will help Indian professional firms to develop system orientation, specialization, profitable use of information technology etc.

5.6 Opening of Branches in other Countries : Indian professional firms have to think of opening branches in other countries with different strategies for developed countries and underdeveloped countries.

5.6.1 In the case of developed countries the clients would like to utilize Indian professional firms' expertise at a lower cost. In that case Indian firms should open their branches with minimum manpower and take up back office functions in India. This will help not only to reduce the cost of service but also to increase the optimum utilization of the professional manpower.

5.6.2 In the case of developing countries the clients would like to utilize the expertise available with Indian Professional firms in areas like Corporate Governance, Accounting, Finance, Legal, Cost Management, Cost Reduction, Management Information System, Introduction of System, System Audit, Risk Management, Restructuring, Merger and Acquisition etc. In order to provide these services it is better that Indian professional firms open branch with full complement of employees to take advantage of high potential opportunities in the developing countries.

5.7 Building of Brand : In India professionals like Company Secretaries, Chartered Accountants and Cost Accountants are allowed to advertise in a very limited way. The Professional Institutes have to re-look at these policies and allow their members to advertise their services with necessary restrictions. This will help Indian Professionals to build their brand.

6. CHANGE MANANGEMENT:

6.1 As Harold L.Sirkin, Perry Keenan and Alak Johnson put it in the October 2005 issue of the Harvard Business Review: "The Hard Side of Change Management" there is need to look at the "DICE" factors in restructuring of firms to prepare for the future.

6.1.1 Direction (D) of Restructuring process with reviews and milestones.

6.1.2 Integrity (I) of Performance and the extent to which one could rely on the terms set up for the change process.

6.1.3 Commitment (C) of the different groups to the process of change as it has to take root.

6.1.4 Effort (E) required to know how to deal with the fact that the existing firms are already entrenched in their past and have to make effort for change.

6.2 Restructuring of professional firms in the GATS regime is a meaningful challenge and has to be systematically approached with a proper review process that is time bound.

NEW INSOLVENCY LAW – THE PRIORITY REFORM

SUMANT BATRA*

Over the last two decades, the Indian financial system has undergone tremendous transformation. Various financial sector reforms have been initiated aimed at promoting an efficient, well-diversified and competitive financial system with the ultimate objective of improving the allocative efficiency of resources so as to accelerate economic development. A part of this is as a result of the opening up of the Indian economy for investment by foreign investors. As India swiftly moves to the centre stage of world economy there has been a consistent effort by the policy makers to undertake comprehensive reforms in the laws and systems to bring them at par with international standards and incentivise the foreign investors to invest in the Indian economy.

An efficient insolvency system is an essential part of a nation's financial architecture needed to encourage enterprise, underpin investment and economic growth and create wealth. It helps in creating a sound climate for investment, enable market participants to more accurately price, manage and control default risks and corporate failure, and encourage sound credit practice. It is vital to stability in commercial relationships and financial systems, advance important social objectives of maintaining public confidence in the corporate and financial sectors and promote sustainable growth in the private sector. It promotes responsible corporate behavior by encouraging higher standards of corporate governance, including financial discipline, to avoid consequences of insolvency; preserve employment through an effective system for rehabilitating financially distressed but viable enterprises, while assuring maximum play in a fair reallocation of assets to more efficient market users through efficient liquidation system.

PREVAILING CORPORATE INSOLVENCY SYSTEM

Indian insolvency law failed to keep pace with the domestic and international developments. Both, the Companies Act, 1956 (1956 Act) under which winding up of companies is carried out and Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) which deals with revival of companies fail to capture the true relevance of the insolvency law besides not meeting the dynamics of the modern economic system. The two laws were enacted to cater to meet the expectations of industries thriving in a protectionist environment unexposed to competition in a closed economy. Both the laws do not provide for engagement of professionals and their skills in the insolvency system.

Thus, the winding up of companies remains a long drawn affair. It takes years in obtaining the statement of affairs, books of account, records and assets, realisation of debts and sale of assets, settlement of list of creditors and contributories, distribution of assets to creditors, members etc. before a company is finally dissolved with the sanction of the court. In the process, substantial corporate assets remain unrealised and undistributed. The inordinate delay in proceedings mars the possibilities of rapid use of productive assets lying dormant throughout the country. The provisions of SICA have been abused by erring debtors to seek protection and moratorium from recovery proceedings. The unscrupulous promoters are easily able to enter into the reference, sometimes by manipulating their accounts to reflect net worth erosion and are then able to attract immunity against the recovery action by the creditors and this benefit is then attempted to be perpetuated. Registration of reference is dependent upon the erosion of net worth and this can be achieved by accounting manipulations. There is no fear of reprisal or punitive

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action against the companies indulging in this malpractice. The inefficiency of the laws led to erosion of the confidence of the key stake holders viz. the creditors who sought alternate measures to recover their assets.

A need has been felt for long for bringing about reforms in this law.

ONSET OF REFORMS

In the year 1999, the Government of India set up a High Level Committee headed by Justice V.B.Eradi, a superannuated Judge of Supreme Court of India to examine and make recommendations with regard to the desirability of changes in existing law relating to winding up of companies so as to achieve more transparency and avoid delays in the final liquidation of the companies; the mechanism through which the management of companies will be conducted after the winding up order is issued and the authority which will supervise timely completion of proceedings; the rules of winding up and adjudication of insolvency of companies; the manner in which the assets of the companies are brought to sale and the proceeds are distributed efficiently; and a self-contained law on winding up of companies having regard to SICA, and the Securities Contracts (Regulation) Act, 1956, with a view to creating confidence in the minds of investors, creditors, labour and shareholders. The committee completed its work and submitted its report to the Central Government in the year 2000.

The committee recommended that the jurisdiction, power and authority relating to winding up of companies should be vested in a National Company Law Tribunal instead of the High Court as at present. In addition, it suggested that the proposed Tribunal shall exercise the jurisdiction and the powers presently exercised by the Company Law Board under the 1956 Act. The committee recommended that the Tribunal should be vested with the functions and power with regard to rehabilitation and revival of sick industrial companies, a mandate presently entrusted with BIFR under SICA. The committee further favoured the appointment of professionals as the Liquidators from a panel to be prepared by the Government. The committee noted the various reasons for the failure of SICA in the revival and rehabilitation of sick industrial companies and recommended the repeal of SICA and the ameliorative, revival and reconstructionist procedures obtaining under it to be reintegrated in a suitably amended form in the structure of the 1956 Act.

Companies (Second Amendment) Act, 2002

In December 2002, the Indian Parliament passed the Companies (Second Amendment) Act, 2002 (Second Amendment) to restructure the 1956 Act leading to the new regime of tackling corporate rescue.

The Second Amendment proposes amendment of the provisions of the 1956 Act for setting up of a National Company Law Tribunal (NCLT) and its Appellate Tribunal. Under the proposed legislation, NCLT will have -

— The power to consider revival and rehabilitation of companies

— The jurisdiction and power relating to winding up of companies

— The jurisdiction & power exercised by the Company Law Board under the 1956 Act. The Company Law Board will stand abolished.

The Second Amendment has introduced some significant improvements in the law. While proposing to establish a special tribunal for supervising insolvency cases, it seeks improve upon the standards to be adopted to measure the competence, performance and services of a bankruptcy court by providing specialized qualification for appointment of members of NCLT and a transparent process for their selection and appointment. It provides for appointment of firm of Chartered Accountants, Cost Accountants, Lawyers and Company Secretaries as liquidator. The Second Amendment provides for a specific provision for debtor to disclose the relevant information in liquidation proceedings. It has further been provided that where a petition for winding up is opposed, that company shall file its statement of affairs, last known addresses of all directors and company secretary, details of location of assets and their value, details of debtors and creditors with addresses, details of workmen/employees and of the amount outstanding to them and such other details as may be specified.

The Second Amendment introduces a provision for levy and collection of cess for the purposes of rehabilitation or revival or protection of assets of the sick industrial company at such rate not less than 0.005 per cent and not more than 0.1 per cent on the value of turn over of every company or its annual gross receipt which ever is more.

It also requires the creation and setting up of a Rehabilitation and Revival Fund. The sources from which amounts will be credited to the Fund have also been specified. This fund will be transferred to the Consolidated Fund of India and amount released to NCLT from time to time for the purposes specified in the Second Amendment. The good companies term this provision as a premium on good businesses.

The Government of India notified certain selective provisions to facilitate the setting up of the NCLT and making appointments of chairman and members. The intention is to set up the Tribunal, create infrastructure and then notify other provisions to provide jurisdiction to Tribunals. The implementation of the Second Amendment however suffered a setback when earlier this year Madras High Court set aside certain provisions of the Amendment on a challenge made by the Bar Association of that court bringing to a grinding halt the setting up of the NCLT. The High Court found a few provisions relating to appointment and conditions of service of Members of Tribunal as unconstitutional. The matter is currently before the Supreme Court of India in an appeal preferred by the Government of India.

Rest of the provisions of the Second Amendment are, however, yet to be notified and the SICA still has not pulled its shutters down as the Sick Industrial Companies (Special Provisions) Repeal Act 2002 passed by the Parliament is awaiting notification. Till then, while BIFR continues to deal with revival and rehabilitation of companies, the High Court retains its jurisdiction as the liquidation court under the 1956 Act.

ON GOING REFORMS: DR. J J IRANI COMMITTEE

The Second Amendment has been received by stakeholders with caution. The alternative mechanism under the Second Amendment is being perceived as an old tablet in a new foil. The powers and jurisdiction of BIFR are now to lie with the Tribunal with some cosmetic changes with the only substantial difference being that while the BIFR had the responsibility of attempting revival of dying companies, the Tribunal will have to not only attempt revival but also perform the last rites if the attempt to revive fails. A closer look at some of the provisions of the legislation sets in a realization that there is a lot more required to be done to make the said laws predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system.

Also, the Second Amendment does little to expedite and simplify insolvency procedures. Barring a few significant changes, the Second Amendment does little to solve the problems faced under SICA. No significant change is made to expedite the liquidation process and make the process efficient. The Indian experience with rehabilitation has been so disappointing that there has been a knee jerk reaction by taking away the moratorium provision, which, under SICA, sounded the death bell for many creditors. In the existing provisions of SICA, it was experienced that the entry level for seeking ameliorative measures by the sick unit was too late owing to the criterion of hundred percent erosion of net worth. Under the Second Amendment, fifty per cent of erosion in average net worth for the last four years of the reference year or three successive defaults in paying installments to the creditors becomes the deciding factor for entry-level eligibility of a sick unit. However, the objective of bringing into purview of NCLT, a case of incipient sickness would be defeated considering the period of 180 days and a further extension by a further time period of 90 days being provided for filing a reference.

In other words, the Second Amendment does not provide a comprehensive Bankruptcy law to deal with corporate bankruptcy. In the fast changing scenario of growing cross-border investment, trade and commerce, cross-border insolvency problems are bound to increase and a comprehensive Bankruptcy law alone can address such issues taking into consideration international practices. It does not introduce the required road map of the bankruptcy proceedings viz. application for initiating bankruptcy proceedings; appointment and empowerment of the Administrator; operational and functional independence; accountability to the court, including the power of the court to remove Administrator in case of mismanagement; relationship with current management; monitoring or substitution; day-to-day operation, etc; time bound restructuring/recognition plan: who should submit; procedure of acceptance; mechanism to sell off; pro-active initiative of the Administrator; number of time-bound attempts for restructuring: decision to go for insolvency and winding up; and strategies for realization and distribution.

Setting up of Dr. J. J. Irani expert committee on company law offered an excellent opportunity to deal with weaknesses in Second Amendment. The finalization, in the meanwhile of Draft Legislative Guide on Insolvency

Law by UNCITRAL provides an opportunity to review the Second Amendment in the backdrop of the Guide. The World Bank's on going Reports on Observance of Standards and Codes (ROSC) Insolvency and Creditors Right Assessment is also expected to make key recommendations to bring the Indian regime in tune with international benchmarks.

J J IRANI COMMITTEE RECOMMENDATIONS

On 31 May 2005 Dr. J.J.Irani Expert Committee on Company Law handed its report to the Government of India. The Committee was set up by the Government to recommend a new company law including the insolvency law as a part of the on-going legal and financial sector reform process in the country.

The Committee has proposed significant changes in the law to make the restructuring and liquidation process speedy, efficient and effective. Recommendations are directed at restoring the eroded confidence of key stakeholders in the insolvency system while balancing their interest.

Following are the key recommendations of the committee:

Time Bound Proceedings

The committee has proposed a definite and predictable time frame for attempt at rehabilitation and for the liquidation process. A period of one year has been proposed for rehabilitation process from commencement of the process till sanction of a plan. A time frame of two years is recommended for the liquidation process to be completed. A fixed time period should be provided for 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.

Applicability and Accessibility

The committee has proposed that the insolvency process should apply to all enterprises or corporate entities including small and medium enterprises except banks, financial institutions and insurance companies. Currently it is applicable only to scheduled industries as described under Industries Development and Regulation Act. The concept of sick industrial company should be replaced by insolvent company or enterprise to bring it in harmony with the principles of the proposed Insolvency Law.

The committee has proposed that rather than erosion of net worth principle, test should prescribe default in payment of matured debt on demand (liquidity test) within a prescribed period. While facilitating the invocation of process at an early stage, this would discourage manipulation of accounts to create erosion in net-worth.

Both debtor and creditors being at least 3/4th in value should also be liable to file a scheme for rehabilitation. The law should require the provision of relevant information about the debtor to be made available for effective consideration of the scheme.

Duties and Prohibitions

The committee has proposed that on admission of application for rehabilitation, the law should impose certain duties and prohibitions to apply to debtors and creditors for an effective resolution of insolvency and balancing the stakeholders' interests in the process. There should be an automatic prohibition on debtors' rights to undertake transfer, sale or disposition of assets or parts of the business. Permission may be granted only to the extent necessary to operate the business, with the approval of the Tribunal. This would protect the assets, build confidence of secured creditors and encourage them to participate in the insolvency process.

Moratorium and Suspension of Proceedings

The committee has recommended that a limited standstill period is essential to provide an opportunity to genuine business to explore re-structuring. The law should, therefore, impose a prohibition on the unauthorized disposition of the debtors' assets and suspension of actions by creditors to enforce their rights or remedies against the debtor on the assets for a limited prescribed period to preserve and protect assets besides maximizing its value. Rather than being automatic, the prohibitions should be on Tribunal's order on a specific application with approval of majority creditors in value. The Tribunal should have adequate power to lift or modify the prohibition in case the circumstances so warrant.

Substitution of Debtor

The committee has recommended that capacity for management of the affairs of the business by debtors should be put to test in consultation with secured creditors. Otherwise creditors should be provided rights of substitution of debtors. Assets should in either case be subjected to supervision or management by impartial, independent, effective and capable Administrator. This would enhance the confidence of the secured creditors in the process while preserving and protecting the assets. Where circumstance justify such as failure to protect assets or deal with them in prejudicial manner, in the opinion of the Tribunal or majority creditors, full control of assets may be allowed to pass to administrator nominated by creditors through exercise of right of substitution.

Operating Agency

It has been recommended that in furtherance of achieving a fair, independent and balanced resolution of stakeholders interest, the committee recommended that role of Operating Agency envisaged under the existing law should be performed by an independent Administrator or such other qualified professional as may be prescribed. Currently banks and financial institutions are appointed as Operating Agency.

Administrator

It has been recommended that the management of the going concern should be replaced by a qualified Administrator appointed by the Tribunal in consultation with the secured creditors with board authority to administer the estate in the interest of all stake holders. An independent Administrator would be able to provide the best treatment to the assets and preserve its value and take other necessary decisions in the best interest of the business. The Administrator should prepare and file a scheme for turnaround of the company, if the business is viable in which case the creditors and ex-management should have an opportunity to comment on the scheme. The Administrator should have the same obligation as the management to secured creditors with right of information and supervision.

Creditors Committe

The committee has recommended establishment of creditors committee. The Committee should enable creditors to actively participate in the insolvency process, monitor the process, and serve as a conduit for processing and distributing relevant information to other creditors and organizing creditors to decide on critical issues. This would provide a platform to all kinds of secured creditors to discuss the divergent views and build consensus and agreement on the issues that arise for consideration and decision. The Law should enable appointment of professional experts and specialists by Creditor Committee to advise them on various technical and legal issues. Directors of a debtor corporation should be required to attend meetings of Creditors Committee so that the decisions can be made on a well informed basis. Unsecured creditors have no representation in the restructuring process. A separate Committee to represent other categories of creditors and unsecured creditors and stakeholders could be formed with limited right to represent and hearing without right to vote on the plan and other decisions. Separate and independent rules for appointment of the creditors (other than secured) committee may be made with details of procedures for membership, quorum and voting rules, powers etc. The law should provide for mechanism to recognize and record claims of unsecured creditors in preparation of the rehabilitation plan.

Liquidators

It has been recommended that a panel of Liquidators should be prepared and maintained by an independent body out of professionals with appropriate experience and knowledge of insolvency practice. The panel should be of individual advocates, accountants, company secretaries, costs and works accountants and other experts rather than the firms so that the independence and accountability of individuals may be determined. The panel should be prepared in a fair and transparent manner. This would also ensure that appropriate professionals who are appointed on the strength of their knowledge and experience provide the service rather than the other partners or colleagues in their firms. The law should however provide power to the Tribunal to make exceptions to the rule and appoint firms. The Tribunal should have powers to appoint Liquidators out of the panel maintained by the independent body and Official Liquidators from panel of officials made available by the Government.

Treatment of Assets in Insolvency

Irani committee has recommended that law should provide a framework that incentivises maximization of estate value. The law should identify the assets that constitute the insolvency estate including assets of debtor (including those subject to security interest) and third party owned assets (such as leased and hypothecated assets) wherever located and provide for collection of assets forming part of insolvency estate by Administrator/ Liquidator. In the cases of rehabilitation, leased assets should form part of insolvency estate. The law should provide for avoidance or cancellation of pre-bankruptcy fraudulent and preferential transactions, completed when the enterprise was insolvent or that resulted in its insolvency. The law should prescribe a flexible but transparent system for disposal of assets efficiently and at maximum values including sale by private treaty. Where necessary, the law may allow for sales free and clear of security interests, charges or other encumbrances, subject to preserving the priority of interests in the proceeds from assets disposal. The sale of assets should be carried out by the Administrator/ Liquidator under the supervision of court.

Treatment of Stake holders

The committee has recommended that the rights and priorities of creditors established prior to insolvency under commercial laws should be upheld to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationship. The status of secured creditors should be *pari passu* with employees in respect of their claims after payment of claims related to costs and expenses of administration of liquidation. Remaining proceeds should be distributed, *pari passu* with other creditors, unless there are compelling reasons to justify giving preferential status to a particular debt. The number of priority classes should be kept to minimum so that rights and expectations of classes created prior to insolvency are not diluted. Public interests, Government claims should not get precedence over private rights in the Insolvency process. Assets are created in the enterprise by the secured creditors who have a prior right over the proceeds when assets are liquidated. The dues of others arise due to the activity these assets create and should be collected when the business is running.

Voting and Approval of Plan

Revival/rehabilitation plan should be approved by majority of secured creditors (75%) to bind all creditors. This would ensure that a small creditor is not able to stall the entire process even though the majority of the creditors are in favour of the plan. In case no plan is approved, the business concern should automatically be liquidated. There should also be enabling provisions to establish a mechanism for filing a negotiated plan for approval by Tribunal by the same majority class of creditors along with disclosure statements etc. and with supporting evidence of approval by majority.

Insolvency Practitioners

Currently, the Indian law does not support effective participation of professionals and experts in the Insolvency process. The committee noted that professionals can play a meaningful role in all aspects of process. Insolvency practice can also open up a new field of activity for service professionals while improving the quality of intervention at all levels during rehabilitation/winding up/liquidation proceedings. Law should encourage and recognize the concept of Insolvency Practitioners (Administrators, Liquidators, Turnaround Specialists, and Valuers etc). Greater responsibility and authority should be given to Insolvency Practitioners under the supervision of the Tribunal to maximize resource use and application of skills.

Costs of Insolvency

The law should create the mechanism for debtor to meet the cost of rehabilitation and liquidation. In liquidation process, the law should facilitate quick disposal of assets to meet the balance cost of the insolvency. Efforts should be made to generate funds to meet the cost of restructuring by disposal of surplus assets, if any of the company. However, the banks/financial institutions should, therefore, approach the new framework, which was consistent with international practices in a positive manner and participate meaningfully in such exercises.

The Committee recommended repeal of the provision of Rehabilitation Cess introduced by Second Amendment. The Committee took the view that an Insolvency Fund may be set up to meet the costs of the insolvency process. Companies may contribute to the Fund on their own option. The corpus of the Fund may also be enhanced by grants from the Government. Government should consider providing incentives, including tax incentives to encourage contributions by companies to such a Fund. Contributions by companies to such a Fund should entitle them to certain drawing rights in the event of insolvency. A company under restructuring and liquidation should be able to draw out of the Fund only in proportion of the contribution made by it to the Fund in the pre-restructuring and pre-liquidation period. This would enable high risk companies to decide on the optimum contribution to be made to the fund. The application of the Fund to the insolvency/rehabilitation process should be subject to the orders of the Tribunal. The Tribunal may, in suitable circumstances allow an over draft from the Fund in the rehabilitation process, in which case the overdraft amount should be shown against the credit of the company and provision of its repayment should be made in the rehabilitation scheme. Insolvency Fund should be credited to a separate account and not to the Consolidated Fund of India. The Fund should be managed by an independent Administrator appointed by the Government.

Cross Border Insolvency

Insolvency laws should provide for rules of jurisdiction, recognition of foreign judgments, co-operation and assistance among courts in different countries and choice of Law. Many countries have already adopted the UNCITRAL Model Law on Cross Border Insolvency with or without modifications. Adoption of the Model Law by India may also be considered with suitable modifications keeping pace with its adoption by countries having significant trade / investment linkages with India. The law should contain enabling provisions to deal with issues concerning treaties and arrangements entered into with different countries by India, present and future. India has developed commercial relationship with new countries in recent years and there would be more new business relationships in future leading to treaties and arrangements from time to time. The law should facilitate recognition of jurisdiction, courts, judgements, cooperation and assistance from these countries.

CONCLUSION

The recommendation of Committee when translated into law will bring the Indian law at par with international standards. The recommendations are based on established global principles such as UNCITRAL legislative guide on insolvency law.

However, any sound legislative framework for its success is dependent upon predictable and effective judicial process coupled with efficacious enforcement mechanisms. There is a need to focus and improve upon our implementation and execution mechanism. Also, there is a need for more creative and commercial approach to corporate entities in financial distress and attempt to revive them rather than applying the more traditional and conservative approach of liquidation or bankruptcy. As such, the socio-economic compulsions dictate that before liquidating financially distressed companies, some attempts must be made towards corporate rescue operations. The quality and skills of judges, newly appointed or existing will need to be reinforced by continuing appropriate training.

The new law would offer tremendous potential to professionals to provide services in various forms through the insolvency process. The professionals need to prepare for provision of such expert and specialized services. The respective professional bodies would be required to prioritize the construction of appropriate education and training programmes for their members.

The international and domestic business and financial community are keenly observing the developments in our country on this front. Many global investors are waiting at the India doorsteps waiting for the new insolvency law to be enacted so that they can start making investments. It is hoped that the Bill would be introduced in the Parliament and passed as a law at the earliest.