CORPORATE GOVERNANCE IN INDIA: DISCIPLINING THE DOMINANT SHAREHOLDER

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ABSTRACT

The nascent debate on corporate governance in India has tended to draw heavily on the large Anglo-American literature on the subject. This paper argues however that the corporate governance problems in India are very different. The governance issue in the US or the UK is essentially that of disciplining the management who have ceased to be effectively accountable to the owners. The problem in the Indian corporate sector (be it the public sector, the multinationals or the Indian private sector) is that of disciplining the dominant shareholder and protecting the minority shareholders. Clearly, the problem of corporate governance abuses by the dominant shareholder can be solved only by forces outside the company itself. The paper discusses the role of two such forces - the regulator and the capital market.

Regulators face a difficult dilemma in that correction of governance abuses perpetrated by a dominant shareholder would often imply a micro-management of routine business decisions which lie beyond the regulators' mandate or competence. The capital market on the other hand lacks the coercive power of the regulator, but it has the ability to make business judgements.

The paper discusses the increasing power of the capital market to discipline the dominant

shareholder by denying him access to the capital market. The newly unleashed forces of deregulation, disintermediation, institutionalization, globalization and tax reforms are making the minority shareholder more powerful and are forcing the companies to adopt healthier governance practices. These trends are expected to become even stronger in future. Regulators can facilitate the process by measures such as: enhancing the scope, frequency, quality and reliability of information disclosures; promoting an efficient market for corporate control; restructuring or privatizing the large public sector institutional investors; and reforming bankruptcy and related laws. In short, the key to better corporate governance in India today lies in a more efficient and vibrant capital market. Of course, things could change in future if Indian corporate structures also approach the Anglo-American pattern of near complete separation of management and ownership Issues of corporate governance have been hotly debated in the United States and Europe over the last decade or two. In India, these issues have come to the fore only in the last couple of years. Naturally, the debate in India has drawn heavily on the British and American literature on corporate governance. There has been a tendency to focus on the same issues and proffer the same solutions. For example, the corporate governance code proposed by the Confederation of Indian Industry (Bajaj, 1997) is modelled on the lines of the Cadbury Committee (Cadbury, 1992) in the United Kingdom. This paper argues however that the crucial issues in Indian corporate governance are very different from those in the US or the UK. Consequently, the corporate governance problems in India require very different solutions at this stage of our corporate development.

The corporate governance literature in the US and the UK focuses on the role of the Board as a bridge between the owners and the management (see for example; Cadbury, 1992; Salmon, 1993; Ward, 1997). In an environment in which ownership and management have become widely separated, the owners are unable to exercise effective control over the management or the Board. The management becomes self perpetuating and the composition of the Board itself is largely influenced by the likes and dislikes of the Chief Executive Officer (CEO). Corporate governance reforms in the US and UK have focused on making the Board independent of the

CEO. Many companies have set up a Nominations Committee of the Board to enable the Board to recruit independent and talented members. There is now increased recognition of the role that the Board could play in providing a strategic vision to the company. The Compensation Committee of the Board has been strengthened to exercise greater control over CEO compensation following widespread complaints that top management pay is disproportionate to performance. There is also a great deal of discussion in the literature on the role of the Board in firing non performing management and in managing the CEO succession. Perhaps the most powerful and well established of the Board committees is the Audit Committee. Apart from acting as a deterrent against financial improprieties and frauds, the Audit Committee also enables the Board to keep a pulse on the financial health of the company.

Turning to the Indian scene, one finds increasing concern about improving the performance of the Board. This is doubtless an important issue, but a close analysis of the ground reality in India would force one to conclude that the Board is not really central to the corporate governance malaise in India. As elaborated at length in this paper, the central problem in Indian corporate governance is not a conflict between management and owners as in the US and the UK, but a conflict between the dominant shareholders and the minority shareholders. The Board cannot even in theory resolve this conflict. One can in principle visualize an effective Board which can discipline the management. At least in theory, management exercises only such powers as are delegated to it by the Board. But, how can one, even in theory, envisage a Board that can discipline the dominant shareholders from whom the Board derives all its powers? Some of the most glaring abuses of corporate governance in India have been defended on the principle of "shareholder democracy" since they have been sanctioned by resolutions of the general body of shareholders. The Board is indeed powerless to prevent such abuses. It is indeed self evident that the remedies against these abuses can lie only outside the company itself.

It is useful at this point to take a closer look at corporate governance abuses by dominant shareholders in India. The problem of the dominant shareholder arises in three large *categories of Indian companies. First are the public sector units (PSUs) where the government is the dominant (in fact, majority) shareholder and the general public holds a minority stake (often as little as 20%). Second are the multi- national companies (MNCs) where the foreign parent is the dominant (in most cases, majority) shareholder. Third are the Indian business groups where the promoters (together with their friends and relatives) are the dominant shareholders with large minority stakes, government owned financial institutions hold a comparable stake, and the balance is held by the general public. The governance problems posed by the dominant shareholders in these three categories of companies are slightly different.*

Public Sector Units (PSUs)

The governance structures of PSUs date back to the days when they were typically wholly owned by the government and were merely an extended arm of the state. These structures allowed the administrative departments in the concerned ministry to exercise virtually complete control over the functioning of these enterprises. It is now evident that these structures are incompatible with the efficient and successful operation of the PSUs in an increasingly competitive and deregulated economy. These issues are discussed extensively elsewhere in this volume (Vittal, 1997), and I shall not go into them again here.

It is interesting however to observe how totally irrelevant the Board really is in the governance of the PSUs today. The Board has no role to play in any of the areas where US and UK reformers have sought to strengthen the Board. The Board has very little say in the selection of the CEO or in the composition of the Board. The government as the majority shareholder takes these decisions through the concerned ministry with the help of the Public Enterprises Selection Board. The Board cannot fire the CEO nor can it vary his compensation package. As far as audit is concerned, again the dominant role is that of the Comptroller and Auditor General (CAG). There is very little that an Audit Committee could add to what the CAG does.

In many PSUs, the Board may still be powerful on paper because the delegation of financial and operating powers to the CEO is very limited. Many operating decisions have to be brought to the Board for decision making. This does not however make for an effective Board because it pushes the Board into "managing" rather than "directing". As discussed elsewhere

in this volume (Balasubramaniam, 1997), there is a clear difference between directing and managing, and the Board's legitimate function is directing. The current governance structure allows the Board to play a highly obstructive role if it chooses by opposing the CEO on operational matters. What it does not allow the Board to do is to play a meaningful strategic role since all strategic decisions are taken by the dominant shareholder through the concerned ministry.

The more interesting issue which has not received much attention so far is the potential that exists for conflict between the dominant shareholder and the minority (public) shareholders. There was a well-known case a few years ago where a dispute of several billion rupees arose between two PSUs. One of these was wholly owned by the government while in the other there was a minuscule public shareholding. The government sided with the wholly owned forced PSU and forced the other PSU to pay up the disputed amount, and the impact on the earnings of the concerned PSU was quite substantial. The merits of the dispute apart, there is a serious corporate governance problem in the resolution of the dispute in this manner without either arms' length negotiation or a resort to a judicial process. A minority shareholder could certainly have regarded it as a simple case of enrichment of the dominant shareholder at the expense of the minority shareholder. As government divestiture of minority stakes in PSUs gathers pace, conflicts of this kind would become more frequent and more serious.

Multi National Corporations (MNCs)

Government regulations have required most MNCs in India to operate through subsidiaries which are not 100% owned by the parent. In the 70s, the government enacted a law limiting foreign ownership in most industries to 40% while allowing 51% in a few high technology areas. This law was liberalized in the 90s and now 51% is permitted in most industries while 74% or even 100% ownership is allowed in some cases. These regulations have created severe corporate governance problems in several key areas as may be seen from the examples below.

In the 70s, MNCs were forced to issue shares to the Indian public to comply with the law. The controls that then existed on pricing of public issues meant that these issues were at substantial discounts to the market price. In the 90s when the law permitted higher foreign ownership, these MNCs raised the foreign stake by issuing shares at very deep discounts to the market price. This obviously meant a large loss to the minority shareholders. One particular case where shares were issued to the parent at less than one-tenth the market price was analysed in detail by Barua and Varma (1993a and 1993b). They calculated that the net gain to the foreign parent after compensating for the loss that it suffered in the 70s (together with interest thereon at market rates of interest) amounted to over $200 million. This and other similar share issues by MNCs were made with the explicit consent of the shareholders in general meeting. The parent companies with their dominant shareholding were able to get the resolutions passed with impressive majorities. In fact when the government introduced regulations to prevent such preferential issues, the MNCs protested against what they called an assault on “shareholder democracy”.

Another corporate governance problem arises where the foreign parent has two subsidiaries in India in one of which it holds a higher stake (say 100%) while in the other it holds a smaller stake (say 51%). The manner in which the MNC structures its business in India between these two subsidiaries is riddled with problems as far as the minority shareholder is concerned. There have been allegations in some cases that the most profitable brands and businesses have been transferred from the long established 51% subsidiary to the newly formed 100% subsidiary at artificially low prices. This implies a large loss to the minority shareholders of the 51% subsidiary who have after all contributed to in equal measure to the investments that were made in the past to build up these businesses to their current dominant position.

Yet another problem is the payments that parent companies increasingly demand for all the services that they provide to their subsidiaries. One well-known example involves a company where the parent has recently started collecting royalties for the use of a brand. In this case, India is actually the principal market for this brand and the Indian company had assiduously cultivated the brand through decades of advertising paid for in part by the minority shareholders. Minority shareholders could only watch in dismay as the royalties knocked off a sizeable chunk of the earnings of the company.

Indian Business Groups

The situation in this category of companies is more complex than in the PSUs and the MNCs where there are clearly defined dominant shareholders. In the Indian business groups, the concept of dominant shareholders is more amorphous for two reasons. First, the promoters' shareholding is spread across several friends and relatives as well as corporate entities. It is sometimes difficult to establish the total effective holding of this group. Second, the aggregate holding of all these entities taken together is typically well below a majority stake. In many cases, the promoter may not even be the largest single shareholder. What makes the promoters the dominant shareholders is that a large chunk of the shares is held by state owned financial institutions which have historically played a passive role. So passive have they been that in the few cases where they did become involved in corporate governance issues, they were widely seen as acting at the behest of their political masters and not in pursuance of their financial interests. So long as the financial institutions play a passive role, the promoters are effectively dominant shareholders and are able to get general body approval for all their actions.

This allows the promoters to play all the games that dominant shareholders play in PSUs and MNCs - structuring of businesses and transfer of assets between group companies, preferential allotments of shares to the dominant shareholder, payments for "services" to closely held group companies and so on. But there are a number of new games too. Over several decades of the command economy, a large parallel black economy has developed in India where transactions are carried out in cash and are not recorded in the books of accounts. Some industries were at one stage so strongly permeated by the black economy that it was almost impossible to carry on business without using black money. Though there have been several honourable exceptions, many Indian business groups have succumbed to the lure of black money. The literature on black money views it primarily as a means of cheating the government of its legitimate dues. But the fact that it is not accounted for in the company's books means that it is also cheating the minority shareholders. Quite often when a company makes losses in its books, the true picture of the business is much healthier because of the profits pouring in in the form of black money. It is a standard joke among bankers in India that there are many financially sick companies but no financially sick promoters.

The situation in some of these business groups is strongly reminiscent of what the father of economics, Adam Smith, wrote over two centuries ago about the rampant corruption in the East India Company:

> "Frequently, a man of great fortune, sometimes even a man of small fortune is willing to purchase a thousand pounds share in India stock merely for the influence which he expects to acquire by a vote in the court of proprietors. It gives him a share, though not in the plunder, yet in the appointment of the plunderers of India ... Provided he can enjoy this influence for a few years, and thereby provide for a certain number of his friends, he cares little about the dividend, or even the value of the stock upon which his vote is founded" (Smith, 1776, Book V, Chapter I, Part III, Article 1st).

Tax reforms coupled with economic liberalization have tilted the balance away from black money transactions. This is partly because tax rates are now lower, and partly because increasing scale economies make it more difficult to operate with the informal organizational structures and financial arrangements that black money entails. It is to be hoped that tax reforms, deregulation and competition would gradually reduce the role of black money to the point where it is confined to isolated cases of corruption.

Another important corporate governance issue is that of mergers and restructuring of companies in the same group. There have been several instances where the valuation of two group companies for the purpose of merger has been perceived to be biased in favour of one of the companies. It has been alleged that in many of these cases, the promoters had secretly built up large positions in this company as a cheap means of acquiring shares of the merged company. The amorphous nature of the promoter group makes it very difficult to verify these allegations. Mergers are subject to approval by shareholder bodies of both companies as well as judicial review. But shareholder democracy is an empty defence against the dominant shareholder.

The Regulatory Dilemma

Regulators face a number of difficulties in tackling the problem of corporate governance abuses by the dominant shareholders. In many cases, it is difficult to decide how far the regulator should go in interfering with the normal course of corporate functioning. Some of these problems are highlighted below.

Shareholder Democracy

A much talked about regulatory dilemma is that of balancing the rights of minority shareholders against the principle of shareholder democracy. On closer examination, this regulatory dilemma is not as serious as it might appear at first sight. In many ways, the very term shareholder democracy represents a misguided analogy between political governance and corporate governance. Unlike political governance, corporate governance is primarily contractual in nature, and corporate governance is at bottom a matter of enforcing the spirit of this contractual relationship.

It is important to bear in mind that the relation between the company and its shareholders and the relation between the shareholders *inter-se* is primarily contractual in nature. The memorandum and articles of association of the company constitute the core of this contract and the corporate law provides the framework within which the contracts operate. The essence of this contractual relationship is that each shareholder is entitled to a share in the profits and assets of the company in proportion to his shareholding. Flowing from this is the fact that the Board and the management of the company have a fiduciary responsibility towards each and every shareholder and not just towards the majority or dominant shareholder.

Shareholder democracy is not the essence of the corporate form of business at all. Shares are first and foremost ownership rights - rights to profits and assets. In some cases (non- voting shares for example) that is all there is to it. In other cases, shares also carry some secondary rights including the control rights - rights to appoint the Board and approve certain major decisions. The term shareholder democracy focuses on the secondary and less important part of shareholder rights. Corporate governance ought to be concerned more about ownership rights. If a shareholder's ownership rights have been trampled upon, it is no answer to say that his control rights have been fully respected.

The dilemma of micro-management

Corporate governance abuses perpetrated by a dominant shareholder pose another and far more difficult regulatory dilemma. Regulatory intervention would often imply a micro-management of routine business decisions. In a competitive world, highly complex business decisions have to be taken quickly and smoothly. Subjecting a large number of these decisions to the process of regulatory review would make a travesty of a free economy. In the name of ensuring that corporate decisions are taken in the best interests of the company as a whole (rather than just the dominant shareholder), the regulator would end up running the company by remote control. The company would then effectively become an extended arm of the state.

Regulatory intervention must perforce be confined to a few clearly defined prohibitions and restrictions that require minimal exercise of regulatory discretion. This approach carries with it the danger that broad prohibitions would also stand in the way of many legitimate business transactions. Some examples of these issues are discussed later in this paper.

Regulatory Response: Company Law

The primary protection to minority shareholders is laid down in the company's law. Some of these provisions are the regulatory equivalent of an atom bomb - they are drastic remedies suitable only for the gravest cases of misgovernance.

Protection of minority shareholders

Company law provides that a company can be wound up if the Court is of the opinion that it is just and equitable to do so. This is, of course, the ultimate resort for a shareholder to enforce his ownership rights. Rather than let the value of his shareholding be frittered away by the enrichment of the dominant shareholder, he approaches the court to wind up the company and give him his share of the assets of the company. In most realistic situations, this is hardly a meaningful remedy as the break-up value of a company when it is wound up is far less than its value as a "going concern". It is well known that winding up and other bankruptcy procedures usually lead only to the enrichment of the lawyers and other intermediaries involved.

Company law also provides for another remedy if the minority shareholders can show that the company's affairs are being conducted in a manner prejudicial to the interests of the company or its shareholders to such an extent as to make it just and equitable to wind it up. Instead of approaching the Court, they can approach the Company Law Board (now proposed to be renamed as the Company Law Tribunal). The Company Law Tribunal which is a quasi-judicial body can make suitable orders if it is satisfied that it is just and equitable to wind up the company on these grounds, but that such winding up would unfairly prejudice the members. In particular, the Tribunal may regulate the conduct of the company's affairs in future, order the buyout of the minority shareholders by the other shareholders or by the company itself, set aside or modify certain contracts entered into by the company, or appoint a receiver. The Tribunal could also provide for some directors of the company to be appointed by the Central Government, or by proportional representation. The Tribunal normally entertains such complaints only from a group of shareholders who are at least one hundred in number or constitute 10% of the shareholders by number or by value.

The powers given to the Company Law Tribunal are perhaps more effective remedies than the power of winding up which is vested in the Courts, though one may wonder whether these powers are too sweeping. However their scope is limited to very extreme cases of misgovernance where it is just and equitable to wind up a company.

Special majority

Another safeguard in the company law is the requirement that certain major decisions have to be approved by a special majority of 75% or 90% of the shareholders by value. This may not be an effective safeguard where the dominant shareholders hold a large majority of the shares so that they need to get the approval of only a small chunk of minority shareholders to reach the 75% level. Even otherwise, it may not be a sufficient safeguard if the process of conducting shareholder meetings is not conducive to broader participation by a large section of the shareholding public. The Indian system does not allow for postal ballots. Effective participation by small shareholders is possible only if there is a cost effective way of waging a proxy campaign. This would enable dissenting shareholders to collect proxies from others and prevent measures which are prejudicial to the minority shareholders.

Information disclosure and audit

Company law provides for regular accounting information to be supplied to the shareholders along with a report by the auditors. It also requires that when shareholder approval is sought for various decisions, the company must provide all material facts relating to these resolutions including the interest of directors and their relatives in the matter. Disclosure does not by itself provide the means to block the dominant shareholders, but it is a prerequisite for the minority shareholders to be able to exercise any of the other means available to them. Disclosure is also a vital element in the ability of the capital market to exercise its discipline on the issuers of capital.

Regulatory Response: Securities Law

Historically, most matters relating to the rights of shareholders were governed by the company law. Over the last few decades, in many countries, the responsibility for protection of investors has shifted to the securities law and the securities regulators at least in case of large listed companies. In India, the Securities and Exchange Board of India (SEBI) was set up as a statutory authority in 1992, and has taken a number of initiatives in the area of investor protection.

Information disclosure

As discussed above, the company law itself mandates certain standards of information disclosure both in prospectuses and in annual accounts. SEBI has added substantially to these requirements in an attempt to make these documents more meaningful. Some of these disclosures are important in the context of dealing with the dominant shareholder. One of the most valuable is the information on the performance of other companies in the same group, particularly those companies which have accessed the capital markets in the recent past. This information enables investors to make a judgement about the past conduct of the dominant shareholder and factor that into any future dealings with him.

Promoters' contribution and lock in

Another aspect of the SEBI regulations is that in most public issues, the promoters (typically the dominant shareholders) are required to take a minimum stake of about 20% in the capital of the company and to retain these shares for a minimum lock-in period of about three years. At first sight, it might appear to deal with a problem closer to the US and UK predicaments where the management has only a minuscule stake in the company. This however is not so at all. The SEBI regulations provide an exemption to those companies where there is no identifiable promoter group, that is to say, no dominant shareholder. In other words, if these regulations were copied by US and UK regulators, they would not make much of a difference to most of the companies in those countries as these companies would typically fall in this category of not having an identifiable promoter group. The SEBI regulations deal with a corporate governance problem very different from the US and UK problems. It affects those promoters who might have planned to have a very small equity stake and still be dominant shareholders because of large blocks of passive shareholders. Such promoters would be in the position to exercise effective control while having very little stake in the company itself. Most of their rewards would come not from dividends or from appreciation in share values, but from one sided deals which help them transfer profits to other entities owned by the promoters themselves. Apart from this category of promoters, the SEBI regulations may not be much of a constraint for most dominant shareholders. Many of them might even otherwise plan to have a stake of more than 20% (probably as high as 51%) to exercise unquestioned control.

Pricing of preferential share allotments

Another area in which SEBI has intervened to tackle the dominant shareholder is the pricing rule that it has imposed on preferential allotments. Company law itself provides that new issue of shares must be rights issues to existing shareholders unless the shareholders in general meeting allow the company to issue shares to the general public or to other parties. As has been pointed out earlier in this paper, the requirement of shareholder approval is quite meaningless when there is a dominant shareholder. Many dominant shareholders (both Indian and foreign) responded to the liberalization of the Indian economy by making preferential allotments to themselves at a small fraction of the market price. In 1994, SEBI issued new guidelines on preferential allotment that prohibited preferential allotments at a price lower than the average market price during the last six months.

This regulatory intervention illustrates very nicely the problems that the regulator faces in dealing with governance abuses by the dominant shareholder. There are many situations where it may be in the interests of the company as a whole (and not just the dominant shareholders) to issue equity at below the six monthly average price.

One situation could be where the stock market as a whole has fallen sharply over the last six months and the six monthly averages is far above the prevalent market price. There have been many occasions where the Indian stock market index has fallen by about 50% during a period of six months. One possible regulatory solution to this problem might be to use an average over a significantly shorter period than six months. At the extreme, one may even consider just the closing price on the day on which the allotment is made. However, regulators consciously chose a longer average because they feared perhaps rightly that prices could be easily manipulated for one day or for a few days but not for a longer period like six months. There is an interesting parallel with issues of convertible bonds in international markets where there is a call option to the company. This option is typically based on the market prices for 30 or more consecutive trading days and not just one trading day. This suggests that the six month period mandated by the regulator is perhaps excessive. But it also suggests that free contracting parties see some merit in the idea of an average price over a period of about a month or two as compared to just the closing price on a given day. In other words, the regulatory problem created by averaging can be reduced but cannot perhaps be eliminated. Another situation where compromises may be desirable on price is when the company is making a private placement of equity to large investors in an arms' length transaction. The private placement may be to avoid the costs of a public issue or because the company does not satisfy the entry norms for a public issue. It is well known that a company making a large additional issue of equity (whether by public issue or by private placement) has to price its equity significantly below the ruling market price. Many public issues for example are typically made at discounts of 15-20% to the ruling market price. The prohibition on making preferential issues at a discount would effectively rule out such private placements altogether. At the same time for reasons of size or otherwise, a public issue may be infeasible. The regulatory intervention on preferential allotment may thus have the wholly unintended consequence of denying the company access to the capital market completely. Again, one can think of modifications in the regulations that would exempt arms' length transactions defined in some suitable way, but no such definition can be wholly satisfactory.

In short, this example shows very well how regulatory interventions designed to discipline the dominant shareholder always run the risk of attempting to micro-manage the affairs of the company. This is a dilemma that simply will not go away.

Insider trading

Securities regulators around the world have framed various regulations to deal with the problem of insider trading. The existence of regulations does not necessarily mean that they are enforced. In South Africa, for example, a recent report on insider trading pointed out that in the quarter century that the insider trading law has been in existence in that country, there has not been a single prosecution (King, 1997). The situation is not very much better in many other countries. However, in the United States and the United Kingdom there have been a large number of well publicized and successful actions against insider trading.

Most instances of insider trading have nothing to do with the dominant shareholder. Many of them involve small trades by junior employees who come to know of price sensitive information. In a few instances, insider trading may be indulged in by directors and other senior employees. In the context of this paper, however, the interesting cases are large scale trades by the dominant shareholder. Market gossip has long speculated on the prevalence of such trades in the build up to large mergers especially between group companies. Some promoters have merged small companies in which they have a large stake into a larger more widely held company at a swap ratio which is highly unfavourable to the widely held company. These allegations have been difficult to prove in most instances as the promoters can act through numerous friends, relatives and other fronts. When SEBI recently initiated action for insider against a large multinational in a somewhat different situation, the action proved to be highly controversial and the ultimate resolution of this case remains uncertain.

Take-overs

Instead of directly exploiting all the privileges that his controlling block gives him, the dominant shareholder can choose to sell his entire holding to somebody else. In a well functioning market for corporate control, he can expect to get a premium over the market price equal to the present value of all the privileges that the dominant shareholder can enjoy in future. The take-over regulations in India require that a slice of this cake be shared with other shareholders. The acquirer of a controlling block of shares must make an open offer to the public for at least 20% of the issued share capital of the target company at a price not below what he paid of the controlling block. Of course, if more than 20% of the shareholders want to sell at that price, the acquirer is bound to accept only 20% on a pro-rata basis.

Discipline of the capital market

Corporate governance is such a burning issue for regulators that it is often forgotten that the capital market by itself exercises considerable discipline over the dominant shareholder. Minority investors may rarely attend shareholder meetings where the dice are loaded against them, but they are continuously voting with their wallets. They can vote with their wallets in the primary market by refusing to subscribe to any fresh issues by the company. They can also sell their shares in the secondary market thereby depressing the share price. A cash rich company with no foreseeable need for additional funds can be relatively unconcerned about this kind of action by minority shareholders. Even in this case, however, the dominant shareholder (unless he holds a clear 51%) faces the risk of being ousted in a take-over battle. A depressed share price makes the company an attractive take-over target. A well functioning market for corporate control makes this threat more real.

The most powerful impact of voting with the wallet is on companies with large growth opportunities that have a constant need to approach the capital market for additional funds. For these companies, shareholder disenchantment can be very expensive. In fact, in equilibrium, the price at which such companies can raise funds from the public will reflect the true worth of the business less the present value of all privileges that the market expects the dominant shareholder to extract in future. If these market expectations are fulfilled, the minority shareholders have little cause for complaint since they end up getting what they paid for. The market may be fooled once or twice, but pretty soon they can form a fair idea of the nature of the dominant shareholders and what they are likely to do. It is quite common for investors in India to value a scrip using a standard financial model (like the price-earnings model, dividend discount model or discounted cash flow model) and then to subtract a "management discount" of 15% or 20% depending on the particular management group involved. This management discount reflects the present value of all future losses to the minority shareholder from governance abuses by the dominant shareholder.

This impact is further strengthened when the minority shareholders are large institutions (both domestic and foreign) who, in a sense, act as the gatekeepers to the capital market. When they vote with their wallets and their pens, they have an even more profound effect on the ability of the companies to tap the capital markets. Indian companies that opened their doors to foreign investors have seen this power of the minority shareholder in very stark terms. These investors can perhaps be fooled once as easily as any other intelligent investor, but the next time around, the company finds that its ability to tap the international markets with an offering of Global Depository Receipts (GDRs) or other instrument has practically vanished. In the mid-90s, company after company in India has woken up in this manner to the power that minority shareholders enjoy when they also double up as gatekeepers to the capital market.

The role of gatekeepers is quite crucial when a company accesses the capital market infrequently. When a company comes to the market for the first time, there is no track record on the basis of which the market can assess the damage that the dominant shareholder is likely to do. In well-developed capital markets, large investment banks perform the gate-keeping function of making a judgement about the company and its management. The investment bank definitely is no stranger to the capital markets, and it has a reputation to defend because it needs to come back to the market again and again. The privileged relationship that the investment bank, particularly the lead manager has with the issuer enables it to make a better assessment about the corporate governance of the company involved. This judgement is reflected in its pricing decisions.

It is unfortunate that the domestic financial institutions have played too passive a role so far and have so far failed to exercise their true powers both as large minority shareholders and as potential gatekeepers. The experience of the last few years suggests that a more pro-active role is possible only when these institutions are fully privatized and are driven by their bottom lines rather than by their political bosses. “The apparent failure of government controlled FIs [financial institutions] to monitor companies in their dual capacity as major creditors and major shareholders have much to do with a pervasive anti-incentive structure. ... The long term solution requires questioning the very basis of majority government ownership of the FIs” (Bajaj, 1997). The other possibility is that the government persuades these institutions to divest their shareholdings in corporate India to more transparent private sector institutions.

It is important to emphasize that the role of the institutions in disciplining the dominant shareholder envisaged here - essentially of voting with their wallets - is very different from the shareholder activism that is being projected as a solution to the corporate governance problems in the US and the UK. On the contrary, voting with the wallet is quite the opposite of shareholder activism (Pozen, 1994).

Another aspect of the capital markets is the powerful disciplining power of debt. Unlike the shareholder who is a residual claimant, the debt-holder has contractual rights to receive his interest and principal; he has both the incentive and the ability to monitor the actions of the company. Many serious instances of corporate mis-governance reduce the future earnings stream of the company or the value of its assets. They thereby reduce the ability of the company to service its debt in accordance with contractual obligations. Most debt contracts therefore involve covenants that make it less easy for the dominant shareholder to indulge in gross abuses. The ability of debt-holders to monitor the company is quite high because typically they are large institutions with a strong gate keeping role. In India, the ability of debt-holders to enforce their rights against recalcitrant debtors has been hampered by an inefficient legal system. It is difficult for creditors to foreclose mortgages, seize collateral or obtain decrees. Moreover, the corporate bankruptcy laws work against the creditors by allowing the debtor to remain in possession of the assets for a long period while compromises or other arrangements are worked out. In a well functioning capital market, there is a strong incentive for corporate managements themselves to voluntarily adopt transparent processes and subject themselves to external monitoring to reassure potential investors. An untested management group is likely to find that the market places a “management discount” on them that reflects what the market has come to expect of management groups in general. The management then has every incentive to take steps that will reduce this “management discount” by making governance abuses more difficult. In the last few years, we have seen Indian companies voluntarily accepting international accounting standards though they are not legally binding. They have voluntarily gone for greater disclosures and more transparent governance practices than are mandated by law. They have sought to cultivate an image of being honest with their investors and of being concerned about shareholder value maximization.

What makes capital market discipline so much more attractive than regulatory intervention is that unlike the regulator, the market is very good at micro level judgements and decisions. In fact the market is taking micro decisions all the time. It is its success in doing so that makes it such an efficient allocator of capital. Unlike the regulator, the market is not bound by broad rules and can exercise business judgement. It therefore makes sense for the regulator to pass on as much of the burden of ensuring corporate governance to the markets as possible. The regulator can then concentrate on making the markets more efficient at performing this function. Similar views have been expressed about corporate governance problems even in the United States (Pound, 1993), but they apply with far greater force to the Indian context.

Conclusion

This paper has argued that structural characteristics of the Indian corporate sector make the corporate governance problems in India very different from that in say the US or the UK. The governance issue in the US or the UK is essentially that of disciplining the management who have ceased to be effectively accountable to the owners. The solution has been to improve the functioning of vital organs of the company like the board of directors. The problem in the Indian corporate sector (be it the public sector, the multinationals or the Indian private sector) is that of disciplining the dominant shareholder and protecting the minority shareholders. A board which is accountable to the owners would only be one which is accountable to the dominant shareholder; it would not make the governance problem any easier to solve. Clearly, the problem of corporate governance abuses by the dominant shareholder can be solved only by forces outside the company itself. This paper has discussed the role of two such forces - the regulator (the company law administration as well as the securities regulator) and the capital market.

Corporate governance abuses perpetrated by a dominant shareholder pose a difficult regulatory dilemma in that regulatory intervention would often imply a micro-management of routine business decisions. The regulator is forced to confine himself to broad proscriptions which leave little room for discretionary action. Many corporate governance problems are ill suited to this style of regulation. The capital market on the other hand lacks the coercive power of the regulator. What it has however is the ability to make business judgements and to distinguish between what is in the best interests of the company as a whole as against what is merely in the best interests of the dominant shareholders. The only effective sanction that the market can impose against an offender is to restrict his ability to raise money from the market once again. Denial of market access is a very powerful sanction except where the company is cash rich and has little future needs for funds.

The past few years have witnessed a silent revolution in Indian corporate governance where managements have woken up to the power of minority shareholders who vote with their wallets. In response to this power, the more progressive companies are voluntarily accepting tougher accounting standards and more stringent disclosure norms than are mandated by law. They are also adopting more healthy governance practices.

It is evident that these tendencies would be strengthened by a variety of forces that are acting today and would become stronger in years to come:

· *Deregulation:* Economic reforms have not only increased growth prospects, but they have also made markets more competitive. This means that in order to survive companies will need to invest continuously on a large scale.

· *Disintermediation:* Meanwhile, financial sector reforms have made it imperative for firms to rely on capital markets to a greater degree for their needs of additional capital.

· *Institutionalization:* Simultaneously, the increasing institutionalization of the capital markets has tremendously enhanced the disciplining power of the market.

- *Globalization:* Globalization of our financial markets has exposed issuers, investors and intermediaries to the higher standards of disclosure and corporate governance that prevail in more developed capital markets.

- *Tax reforms:* Tax reforms coupled with deregulation and competition have tilted the balance away from black money transactions. This makes the worst forms of mis-governance less attractive than in the past.

While these factors will make the capital markets more effective in disciplining the dominant shareholder, there are many things that the government and the regulators can do to enhance this ability:

- Disclosure of information is the pre-requisite for the minority shareholders or for the capital market to act against errant managements. The regulator can enhance the scope, frequency, quality and reliability of the information that is disclosed.

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- Regulatory measures that promote an efficient market for corporate control would create an effective threat to some classes of dominant shareholders as discussed earlier.

- Reforms in bankruptcy and related laws would bring the disciplining power of the debt-holders to bear upon recalcitrant managements.

- Large blocks of shares in corporate India are held by public sector financial institutions who have proved to be passive spectators. These shareholdings could be transferred to other investors who could exercise more effective discipline on the company managements. Alternatively, these institutions could be restructured and privatized to make them more vigilant guardians of the wealth that they control.

In short, the key to better corporate governance in India today lies in a more efficient and vibrant capital market. Over a period of time, it is possible that Indian corporate structures may approach the Anglo-American pattern of near complete separation of management and ownership. At that stage, India too would have to grapple with governance issues like empowerment of the board. Until then, these issues which dominate the Anglo-American literature on corporate governance are of peripheral relevance to India.

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