

CORPORATE GOVERNANCE

- RACE TO THE BOTTOM

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By

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INDEX

1. Introduction.....	3
2. All about shares.....	5
3. Issuance of shares.....	6
Issue of shares at discount.....	7
Issue of sweat equity share.....	8
Rights share and bonus share.....	9
4. Buy back of shares.....	11
5. Rights of a shareholder.....	14
6. Liabilities of a shareholder.....	15
7. Voting and poll.....	17
8. Resolution by postal ballots.....	19
9. Corporate governance.....	21
Satyam scam.....	22
10. Ways of manipulation.....	25
11. Recommendation.....	28

INTRODUCTION

Corporate governance is the system by which companies are directed and controlled by the management in the best interest of the shareholders and others ensuring greater transparency and better and timely financial reporting. It is needed to create a corporate culture of consciousness, transparency and openness. It refers to combination of laws, rules, regulations, procedures and voluntary practices to enable the companies to maximise the shareholders long-term value. It should lead to increasing customer satisfaction, shareholder value and wealth. Lately corporate governance has been talked about a lot which is due to multiple scams and small shareholder manipulation happening around us in the corporate world. Thus it is necessary to encourage corporate democracy amongst the minority shareholders and the dominant shareholders.

There are many instances where the minority shareholders have been manipulated by the dominant ones in terms of share prices and all. Thus it has become the need of the hour to empower the minor shareholders so that they can put forward their cases. The manipulations have been in case of the buy-back prices, insider trading leading to fluctuations in share prices, transactions in cash, offer prices etc. thus to prevent the corporate biggies from indulging in such corrupt practices we need stringent mechanism to empower our small shareholders to keep a watch, and stringent punishments for those who indulge in these activities.

Sebi has taken several steps to initiate this by creating several investors' associations, and help lines, there are at present 24 investors' association all around the country and 2 in Delhi itself. They register the grievances of the shareholders which affect the major population of the shareholders and they allocate funds to redress their grievances. The Institute of Chartered Accountants of India have created several accounting standards for the companies. Ficci has also recommended retaining the announcement of bonus shares and rights shares within the ambit of insider trading policy in purview of Sebi in order to curb these practices.

Another issue in obtaining corporate democracy is the lack of participation from the small shareholders in decision making in a company. The means of postal ballot which was incorporated in 2001 for mass participation in the voting was also defeated. This was because only a small fraction of shareholders actually exercised their right of voting. Thus Sebi can come up with a three tier system of voting. The small shareholders in a company

can hold district wise associations where they can vote a representative amongst them who can then hold proxies for the members at the AGM.

Thus ensuring corporate democracy is the first step in obtaining corporate governance. Therefore, the real need of the hour is to empower the investors' associations and educate the investors in terms of their rights and liabilities.

SHARE

Share is not a sum of money but an interest or rights measured in a sum of money to participate in the profits made by the company while it is a going concern, or in the assets of a company when it is wound up. **Thus a share is incorporeal in nature and consists of merely a bundle of rights and obligations.**

Section 82 of Companies Act 1956, states that the nature of shares or debentures or other interest of any member in a company, shall be movable property, transferable in the manner provided by articles of the company.

As per the Section 86 of the Companies (Amendment) Act 2000, the share capital of a company limited by shares can only be of two types:

1. EQUITY SHARE CAPITAL

- a) With voting rights of the shareholders
- b) With differential rights as to dividend, voting or otherwise, in accordance with such rules and subject to such conditions, as may be prescribed.

(As per the decision taken in the SEBI board meeting no listed company can issue shares with superior voting rights. This will avoid the possible misuse by the persons in control to the detriment of public shareholders – decision taken on June 18th, 2009)

2. PREFERENCE SHARE CAPITAL

As per Section 85 (1) preference share capital refers to that part of the share capital which fulfils **both** the following conditions:

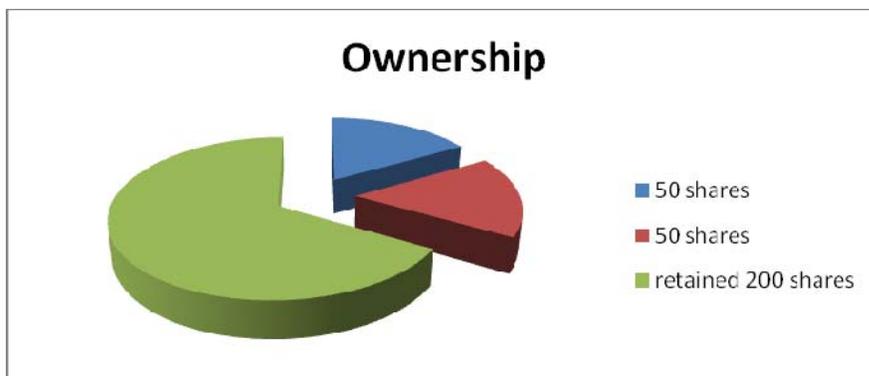
- a) During the life time of the company, it is assured of payment of dividend either at a fixed rate or a fixed amount.
- b) In the event of winding up of the company, it carries a preferential right to be repaid the amount of capital paid up, before anything is paid to the equity share holders.

All the rights and limitations with regard to preference shares are applicable only to a public company or a private company which is a subsidiary of a public company **(Section 90 of**

the Act). This essentially means that a private company is free to create and issue any kind of share capital and on any terms as it may deem fit. Therefore, a private company, through its articles of association, may create preference shares that carry the same or even extra rights as compared to equity shares.

ISSUANCE OF SHARES

The purpose of issuing shares is to control ownership and voting rights for a company. Shares are issued (allotted) to shareholders from the company's share capital in the proportion that will reflect their individual voting and ownership rights. For example if a company has two shareholders each with 50 shares then they have equal voting and ownership rights. If one shareholder has 25 shares and another has 75 shares then the split will be 25% and 75% respectively.



It is important to note that not all the shares from the share capital have to be allotted to the shareholders and it is common to reserve a certain number in the share capital that may be issued at a later date.

The controlling interest of a company is held by the majority shareholder as he will be able to dictate the ordinary resolution being passed in a general meeting.

A shareholder in a company is issued a share certificate from the company stating the value and number of shares issued, the type of shares (ordinary or preference), date of issue, name and address of the recipient etc. the issue share may not be paid in full. But it is considered paid up on the date of issue of the share.

The shares can be held in physical or in dematerialised form. If one is holding shares in a demat account they don't have to possess any physical certificates. They are all held electronically in the account. Just like a bank passbook or statement, the DP will provide you with periodic statements of holdings and transactions.

ISSUE OF SHARES AT DISCOUNT

When a company sells its shares below its face value, it is said that the company is issuing shares at a discount. **Section 79 of the Companies Act** lays down certain conditions which must be complied with by a company (public or private) before it can issue shares at discount.

(i) The issue of the shares at a discount is authorised by a resolution passed by the company in general meeting and sanctioned by the [Central Government]

(ii) the resolution specifies the maximum rate of discount at which the shares are to be issued

[Provided that no such resolution shall be sanctioned by the Central Government if the maximum rate of discount specified in the resolution exceeds ten per cent. [unless the Central Government is of opinion] that a higher percentage of discount may be allowed in the special circumstances of the case]

(iii) not less than one year has at the date of the issue elapsed since the date on which the company was entitled to commence business; and

(iv) the shares to be issued at a discount are issued within two months after the date on which the issue is sanctioned by the [Central Government], or within such extended time as the [Central Government] may allow.

ISSUE OF SWEAT EQUITY SHARE

Sweat equity shares are equity shares which are issued by a company to its employees or its directors, either at a discount or for consideration other than cash in order to reward their employees and directors for bringing in new technology or doing exemplary work.

There are certain conditions for issue of sweat equity under **Section 79 A**:

- (a) The issue of sweat equity shares is authorised by a special resolution passed by the company in the general meeting;
- (b) The resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
- (c) not less than one year has, at the date of the issue elapsed since the date on which the company was entitled to commence business;
- (d) the sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;

SEBI guidelines provide that if sweat equity is issued to promoters, then in addition to a special resolution, an ordinary resolution of the shareholders must also be passed. This can even be done through the postal ballots. Moreover, the promoters to whom the sweat equity is being issued, shall not participate in such resolution.

RIGHTS SHARES AND BONUS SHARE

Section 81 (1) of Companies Act provides that whenever a company proposes to increase the subscribed capital of the company they may issue further shares, it is first to be offered to the existing members of the company. The shares issued to the existing members of the company are called the rights share. According to the provisions of this section

(a) Such shares shall be offered to the persons who, at the date of the offer, are holders of the equity shares of the company, in proportion, as nearly as circumstances admit, to the capital paid-up on those shares at that date;

(b) the offer aforesaid shall be made by notice specifying the number of shares offered and limiting a time not being less than fifteen days from the date of the offer within which the offer, if not accepted, will be deemed to have been declined;

(c) unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice referred to in clause (b) shall contain a statement of this right;

(d) after the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of directors may dispose of them in such manner as they think most beneficial to the company.

The shareholder can individually choose to take up all, some or none of the rights offered to them. The rights can also be sold by the shareholder to a third party. After a rights issue, distributable profits have to be shared over a greater number of shares than previously, resulting in lower earnings per share and a reduced dividend. Shareholders are therefore offered the subscription at a discount as an incentive to take up their rights and maintain their proportionate stake in the company. If they do not take up their rights their stake will be diluted and the value of their holding will be reduced.

Institutional shareowners have the money to take up their rights; personal investors frequently can't afford to take up their rights, the institutional investors can take them up and further increase their holdings. So every time a company has a rights issue, the proportion of shares held by personal investors falls. If the company's share price is high, that may not be so much of a concern; at least the personal investors are getting a decent price for their shares. But if the share price is seriously depressed, this would give a serious financial blow to small investors.

Example: ABC shares have a current market price of 400p per share. They offer a two-for-five rights issue, offering the extra shares at a subscription price of 225p per share. You own 100 shares and as a shareholder have the right to purchase an extra two share for every five shares that you hold i.e. an additional 40 shares (rights share)

Existing share value: $100 * 400p = 400rs$

New share value: $40 * 225p = 90rs$

Average value per share: $490 / 140 = 350rs$

Bonus share: A bonus share is a free share of stock given to current shareholders in a company, based upon the number of shares that the shareholder already owns. While the issue of bonus shares increases the total number of shares issued and owned, it does not increase the value of the company. Although the total number of issued shares increases, the ratio of number of shares held by each shareholder remains constant. An issue of bonus shares is referred to as a bonus issue.

Unlike a rights issue, a bonus issue does not risk diluting our investment. Although the earnings per share of the stock will drop in proportion to the new issue, this is compensated by the fact that one will own more shares. Therefore the value of our investment should remain the same although the price will adjust accordingly. The whole idea behind the issue of Bonus shares is to bring the Nominal Share Capital into line with the true excess of assets over liabilities.

Example: If one holds 100 shares of a company and a 2:1 bonus offer is declared, he gets 200 shares free. That means the total holding of shares in that company will now be 300 instead of 100 at no cost.

A bonus issue is a signal that the company is in a position to service its larger equity.

BUY BACK OF SHARES

Buyback is reverse of issue of shares by a company where it offers to take back its shares owned by the investors at a specified price; this offer can be binding or optional to the investors.

Rationale behind buy backs of shares

Unused Cash: If they have huge cash reserves with not many new profitable projects to invest in and if the company thinks the market price of its share is undervalued. Example, Bajaj Auto went on a massive buy back in 2000 and Reliance's buyback in 2005. When shares are bought back, they are physically destroyed. Hence the number of shares is reduced. This means that now the earning per share of the company increases. From the point of view of the investor the buy back price of the share is generally higher than the prevailing price, and hence the investors benefit by way of return of capital.

Tax Gains Since dividends are taxed at higher rate than capital gains companies prefer buyback to reward their investors instead of distributing cash dividends, as capital gains tax is generally lower. At present, short-term capital gains are taxed at 10% and long-term capital gains are not taxed. [short term capital gain tax if for income on shares traded within 1 year of its issue]

Market perception By buying their shares at a price higher than prevailing market price company signals that its share valuation should be higher. Recently the prices of RIL and REL have not fallen, as expected, despite the spat between the promoters. This is mainly attributed to the buyback offer made at higher prices.

Exit option If a company wants to exit a particular country or wants to close the company.

Escape monitoring of accounts and legal controls If a company wants to avoid the regulations of the market regulator by delisting. They avoid any public scrutiny of its books of accounts.

Show rosier financials Companies try to use buyback method to show better financial ratios. For eg. When a company uses its cash to buy stock, it reduces outstanding shares

and also the assets on the balance sheet (because cash is an asset). Thus, return on assets (ROA) actually increases with reduction in assets, and return on equity (ROE) increases as there is less outstanding equity. If the company earnings are identical before and after the buyback earnings per share (EPS) and the P/E ratio would look better even though earnings did not improve. Since investors carefully scrutinize only EPS and P/E figures, an improvement could jump-start the stock. For this strategy to work in the long term, the stock should truly be undervalued.

Increase promoter's stake Some companies buyback stock to contain the dilution in promoter holding, EPS and reduction in prices arising out of the exercise of ESOPs issued to employees. Any such exercising leads to increase in outstanding shares and to drop in prices. This also gives scope to takeover bids as the share of promoters dilutes. Eg. Technology companies which have issued ESOPs during dot-com boom in 2000-01 have to buyback after exercise of the same. However the logic of buying back stock to protect from hostile takeovers seems not logical. It may be noted that one of the risks of public listing is welcoming hostile takeovers. This is one method of market disciplining the management. Though this type of buyback is touted as protecting over-all interests of the shareholders, it is true only when management is considered as efficient and working in the interests of the shareholders.

HIDDEN MANIPULATIONS

1. Some companies come out with a scheme of buyback wherein, unless the shareholders rejected the offer specifically, in response to the offer letter sent by the company, they would be deemed to have accepted it. Though courts have upheld the action of the companies, it is to be noted that small shareholders generally do not bother to read such letters and respond to the same, and may not understand the complex legal language used in such letters.

2. Some companies make it compulsory for shareholders to sell at a specified price mandated by the company. A shareholder enters a company by choice and mutual agreement and should be entitled to exit only by choice. Forcible buyback of shares at a non-transparent price would be expropriation and should be prevented.

Note: Gov's budget of FY 2002-03 has relaxed buyback rules for the companies by which buyback of shares up to 10% of paid-up capital does not require shareholders approval thus

putting the minority shareholders at the mercy of majority shareholders and promoters.

Restrictions on buyback by Indian companies: as per **Section 77 A (2)**

Some of the features in government regulation for buyback of shares are:

1. A special resolution has to be passed in general meeting of the shareholders
2. Buyback should not exceed 25% of the total paid-up capital and free reserves
3. A declaration of solvency has to be filed with SEBI and Registrar Of Companies
4. The shares bought back should be extinguished and physically destroyed;
5. The company should not make any further issue of securities within a period of 6 months except bonus, conversion of warrants, sweat equity etc.

These restrictions were imposed to restrict the companies from using the stock markets as short term money provider apart from protecting interests of small investors.

Valuation of buyback:

There are two ways companies determine the buyback price.

1. They use the average closing price (which is a weighted average for volume) for a period immediately before to the buyback announcement. Based on the trend and value a buyback price is decided
2. Shareholders are invited to sell some or all of their shares within a set price range

Conclusion

It may be remembered that buyback has no impact on the fundamentals of the economy or the company. Therefore investors should be cautious of unscrupulous promoters' traps.

RIGHTS OF A SHAREHOLDER OR A MEMBER

A person who is a shareholder of a company enjoys many rights. Some of these rights are enjoyed by him by virtue of entering into a contract with the company, and some of them are expressly granted by the Companies Act. Some of them are listed below:

1. Right to receive notice of a general meeting
2. Right to vote at all general meetings, either in person or in proxy. In case the member is a body corporate, the right to appoint a representative to attend a general meeting on its behalf.
3. Right to receive dividends or bonus share.
4. Right to pre-emption in relation to new share
5. Right to elect directors
6. Right to remove directors by passing an ordinary resolution
7. Right to apply to the **tribunal**
 - a. For prevention of oppressing and mismanagement (Section 397, 398)
 - b. For investigation of the affairs of the company (Section 235)
 - c. For refusal of a private company to register share and for rectification of register of members (Section 111)
 - d. For calling of an extra ordinary general meeting when impracticable to call or conduct a meeting (Section 186)
8. Right to apply to the central government in case of failure to hold the annual general meeting (Section 167)
9. Right to obtain share certificate from the company within the specified time (Section 113)
10. Right to obtain copies of memorandum and articles of association, annual accounts of company, resolutions and agreements, minutes of proceedings of general meeting.

LIABILITIES OF A SHAREHOLDER OR MEMBER

A member is subject to liabilities and obligations, depending upon the nature of the company of which he is a member.

1. If he's a member of an **unlimited company** he is liable in full for all the debts contracted by the company during his membership.
2. In case of a member of a **company limited by guarantee**, a member is liable not only to pay the unpaid amount on the share but is also liable to pay the amount he has guaranteed to contribute in the event of winding up.
3. A member of a limited liability company is liable only to the extent unpaid on the shares he is holding. If his shares are fully paid his liability is nil.

MEETING AND PROCEEDINGS

Meetings form an integral part of decision making because all the decisions in a company are taken through resolutions passed at meetings of either the directors or the shareholders.

ANNUAL GENERAL MEETING

The annual general meeting is very important because of the nature of the business transacted at it. **Section 166 of the Companies Act** provides that every company, whether public or private, whether with share capital or without, whether limited or unlimited, must hold a meetings of its members each year. Annual general meeting is held in addition to any other meeting held in that year.

The business transacted at general meetings comprise of:

1. Ordinary business
 - a. Consideration of the accounts, balance sheets, auditors and directors report
 - b. The declaration of dividend

- c. The appointment of directors in the place of those retiring
- d. The appointment of auditors and fixation of their remuneration

2. Special business

Any other business other than the mentioned above is called the special business.

An annual general meeting is of great importance for a shareholder, because it is only at this meeting that he can exercise control over the affairs of the company by passing of resolution. Generally ordinary business requires passing of ordinary resolutions and special business a special resolutions.

- The board of Directors is the proper authority to convene an AGM.
- The company must give a clear 21 days notice to all the members, representatives, the auditors of the company and public trustee in respect of share held in trust. The notice must specify the place, the date and the hour of the meeting and must contain a statement of the business to be transacted at the meeting. A copy of director's report, audited annual accounts and auditor's report must accompany the notice.

Every general meeting should be held during the business hour, on a day that is not a public holiday, at either the registered office of the company or at some other place within the city, town or village in which the registered office of the company is situated.

A private company which is not a subsidiary of a public company can hold its AGM at any place irrespective of the place of registered office.

Before a meeting can transact any business the following requirements must be satisfied:

- a. Meeting, must be duly convened by proper authority
- b. Proper notice must be served to all persons entitled to receive it
- c. A quorum must be present (Section 174)

Quorum is defined as the minimum number of members present at the meeting for the business to be transacted validly. In respect of general meetings it is five members in case of a public meeting and 2 in case of any other company.

(it is to be noted that for the purpose of ascertaining the quorum only members present in person, and not in proxies are to be counted)

d. A chairman must preside (Section 175)

(1) Unless the articles of the company otherwise provide, the members personally present at the meeting shall elect one of themselves to be the chairman thereof on a show of hands.

(2) If a poll is demanded on the election of the chairman, it shall be taken forthwith in accordance with the provisions of this Act, the chairman elected on a show of hands exercising all the powers of the chairman under the said provisions.

(3) If some other person is elected chairman as a result of the poll, he shall be chairman for the rest of the meeting.

e. Minutes of the meeting

The minutes book is kept at the registered office of the company and should be open for inspection by the members (for 2 hours at least each day) during business hour and without any charge.

VOTING AND POLL

Whenever a matter is put before the meeting, unanimity on that matter may not be obtained. In such a circumstance, the chairman may put the matter to vote. There are two popular methods of voting:

1. **By show of hands:** Section 177 provides that at any general meeting, voting in the first instance should be by show of hands. Under this method every member has one vote and proxies are not allowed, unless expressly allowed by the articles of the company.

2. **By poll:** In case of voting by show of hands, the results may not reflect the true opinion of members as there are proxies present who can only vote by poll. Again it does not do justice to the members holding larger numbers of shares since he has only one vote. Under this method each member can vote according to the number of shares held by him. One vote for each share.

Voting in different classes of shares

To support with an example, three different classes of shares are given below.

Class of share	Nominal value	Number	Totals
Ordinary A	1.00	500	500
Ordinary B	0.50	1750	875
Ordinary C	0.10	400	40
Total		2650	1,145

Shareholders can hold more than one class share in the same company and benefit from the rights which pertain to each group. The different class of shares offer different benefits in terms of their voting rights, dividends, guarantee or variable dividend, payouts received on winding up.

In the above example, if class B shares were nonvoting then when calculating voting rights they would be removed from the calculations.

Similarly if all three types of shares were eligible to receive dividends the same individual would receive, would have to include classes A, B and C.

RESOLUTION BY POSTAL BALLOTS

It is not always possible for the entire body of shareholders to attend general body meetings to decide important issues. In order to ensure the widest participation shareholders in the key decision making process of the company the facility of passing resolutions through postal ballots was introduced in 2001. **It was under Section 192 A introduced through companies (Amendment) Act 2000.**

List of business in which resolutions can be passed through postal ballots include:

- (a) Alteration in the Object Clause of Memorandum.
- (b) Alteration of Articles of Associations in relation to deletion or insertion of provisions defining private company.
- (c) Buy-back of own shares by the company.
- (d) Issue of shares with differential voting rights as to voting or dividend or otherwise.
- (e) Change in place of Registered Office outside local limits of any city, town or village.
- (f) Sale of whole or substantially the whole of undertaking of a company.
- (g) Giving loans or extending guarantee or providing security in excess of the limit.
- (h) Election of a small shareholders' director.
- (i) Power to compromise or make arrangements with creditors and members.
- (j) Variation in the rights attached to a class of shares or debentures or other securities

Limited success

When this provision was introduced the expectation was that shareholders would participate in corporate democracy in a big way by exercising their right to vote on a resolution put to vote through postal ballot. But ironically the polling percentage has been way below the expected. Ignoring the fact that all the costs in process are borne by the companies and the

investors only have to send the prepaid envelope with their vote. But still the basic essence of corporate democracy remains defeated.

For example:

As per the reports of a firm SKNL (S. Kumars Nationwide Limited) the total votes through postal ballot mechanism where the voting was held in February 2009, was as follows:

S. NO.	PARTICULARS	RESULT
1.	Total number of shareholders as on 31 st January 2009	29545
2.	Total shareholders to whom postal ballots sent	29545
3.	Total shareholders who exercised their votes through postal ballots	206
4.	Total votes(in terms of number of shares through postal ballots)	101427314

So here we see that out of 29545 shareholders only a fraction exercised their voting rights through postal ballots.

CORPORATE GOVERNANCE

Corporate governance is a set of processes, customs, policies, laws, and institutions affecting the way a corporation is directed and controlled. The principle stakeholders are the

- shareholders/members
- management
- board of directors

The main aim of corporate governance is to instil corporate democracy in a firm with well defined rights of all the stakeholders in a company which in turn will strengthen them.

The issue of corporate governance has been arising time and again even after decades of liberalisation of the economy. In the first 10 years of decontrolled capital market have attracted 10 major scams. It is said the Rs. 50000 crores of small investors' savings got lost locked.

Scams till 2000

1. Harshad Mehta scam – year 1992
2. NBFC Companies Scam- year 1995-1998
3. CRB Finance and Mutual Funds Scam of Year 1995-1997
4. Plantation's Company scam- year 1997-1999
5. Vanishing Company's Scam year 1995-1999
6. Name Changing Scam year 1999-2000
7. Dot Com. Company Scam year 1999 2000
8. US-64 Disaster "Gadbud" of year 1997-1998
9. Ketan parekh Scam year 1999 2001
10. UTI Fiasco "Gadbud" year 1994 2000

SATYAM SCAM- 2009

The latest and the biggest scam in Indian history is the SATYAM COMPUTER SERVICES FRAUD. In a shocking revelation, the chairman Mr. B Ramalinga Raju of the fourth largest software exporting company in India accepted fraud on 7th January 2009. A large sum of money was siphoned out of the company using multiple different channels. The money thus retrieved was used for many different purposes.

- The money that was taken out have been used, among other things, to acquire large quantities of land in what seems to be a set of speculative real estate ventures that could enrich the family. The Maytas companies that had titles that spelt Satyam in reverse were important conduits in this process, but there were clearly many more. According to reports, the Registrar of Companies has found that "Satyam's annual report reveals several transactions with subsidiaries and other group companies by way of investments, purchase of assets and other receivables" that point to the concealed transfer of funds out of the company
- Shockingly, one of the allegations made by the Crime Investigation Department (CID) of Andhra Pradesh is that the company had only 40,000 employees on its rolls as compared with the 53,000 claimed by it and the remaining 13,000 were mere fake salary accounts through which as much as Rs. 20 crore a month were taken out of the company over a period of five years.
- The truth is that the stake of the promoters has fallen sharply after 2001 when they reportedly held 25.60 per cent of equity in the company. This fell to 22.26 per cent by the end of March, 2002, 20.74 per cent in 2003, 17.35 per cent in 2004, 15.67 per cent in 2005, 14.02 per cent in 2006, 8.79 in 2007, 8.65 at the end of September 2008 and 5.13 per cent in January 2009. While the last of these declines was due to sales by lenders with whom the promoters' shares were pledged, earlier declines were partly the result of sale of shares by promoters. The promoters are estimated to have sold around four-and- a-half crore shares in the company over a seven-year period starting September 2001. It has been alleged that the company's accounts were manipulated to inflate share values, so that these sales of shares would have delivered large receipts to the promoters. According to one estimate, the promoters could have earned as much as Rs. 2500 crore through the stake sale. (problem of insider trading)

Governance structures are meant to prevent this. One way in which this is done is through the capital market which is seen as a monitoring and disciplining mechanism because it serves as a market for corporate control. Bad managements trigger stock price declines leading to their replacement due to pressure from existing shareholders or from new shareholders who exploit the lower share values to acquire an influential stake in the company. In practice, this kind of monitoring rarely works either because incumbent managements reveal partial or incomplete information or because minority shareholders would find it difficult and costly to fully monitor and discipline managers who put the company's revenues and profits at risk. Moreover, shareholders are beguiled by high stock prices, since they buy into the idea that high and rising stock prices are a sign of both good performance and good management. If accounts are manipulated and revenues and profits inflated, the stock market performance of the company improves, and that improvement serves to conceal the fraud that is under way.

Advocates of regulatory forbearance under a reformed and liberalised capitalism argue, however, that the system has fashioned a governance structure that is explicitly aimed at ensuring compliance and disclosure. That structure is multilayered, consisting of boards of directors which include independent directors expected to represent the interests of the minority shareholders and society at large, auditors who are expected to ensure that the books which provide the information on the performance of the managers and the financial health of the company are in order, regulators who ensure that guidelines with regard to accounting standards, disclosure and good management practices are followed and agencies that can investigate and prosecute in case fraud of any kind is suspected. This combined with international accounting standards and disclosure norms that are ostensibly followed by IT companies was seen as insuring against fraud.

But it was shocking to see that the decision of the promoters of Satyam Computer Services to manipulate accounts, defrauding its investors in the process, was neither sensed nor detected at all of levels of governance. There are a number of factors that seem to underlie this overall failure. To start with there was total failure at the level of the board and the auditors. This huge fraud which occurred over many years and ostensibly left a hole of more than Rs. 7,000 crore was completely missed by a high profile board, which even agreed to allow the promoters to use its non-existent reserves to buy up two unrelated companies in which the promoters have a major stake. The board included independent directors who are

respectable professionals and academics. In addition, the firm's auditors, PwC, one of the big four, failed to detect manipulation of this magnitude, despite the fact that it included claims of huge cash reserves that did not exist. As many have rightly argued, even a minimum of diligence would have proved this claim regarding reserves to be false leading to a detection of the scam.

The question that arises is whether self-regulation failed because these individuals and entities were paid by the company to undertake their role. A similar issue came up after the sub-prime mortgage crisis when observers asked whether the fact that the rating agencies such as Moody's and Standard and Poor, which were to serve as monitors of risk, discounted risk and gave high ratings because they were paid by the firms whose securities they rated. According to reports, independent directors in Satyam Computer Services were being paid huge fees for their professional services, varying from Rs. 12.4 lakh to Rs. 99.48 lakh in 2006-07, in the form of commission, sitting fees and professional fees *(Satyam directors' remuneration", Business Line 30 December, 2008). This gives rise to the criticism that the practice of managements paying independent directors (and paying them well) could lead them to take a soft view of matters and not take their monitoring and correcting role seriously. Further, lack of adequate caps on revenues obtained by auditors from their clients also creates a problem. The search for large fee incomes and competition between auditors to increase market share, does encourage auditors to take the claims of their large clients and the documents they produce at face value, dropping the minimal checks which would possibly have revealed the Satyam fraud. Here again the fact that the monitor is paid by the monitored seems to be a major source of the problem.

WAYS IN WHICH A SMALL SHAREHOLDER CAN BE MANIPULATED

1. **UNFAIR PRICING**: Sebi has a prescribed formula of pricing of open offers – the average share price over the preceding 26 weeks. For example Reckitt Benckiser, the blue chip multinational announced it would make an open offer to buy back shares from its shareholders at rs. 250 a share and delist the stock from the bourses. The offer price represented a 15% premium over the market price (Rs. 217) on the date of the announcement and a 38% mark-up over the price as would have been worked out under Sebi's guidelines. The small shareholders were cheated here. Initially the stock prices of its shares was pretty high for quite some time but it fell sharply only in the past year due to poor operational performance and bad market conditions. Full year profits were flat, against 51% growth the previous year. Thus to have capitalised on depressed market conditions or sub normal performances to buy back shares at valuations that do no justice to minority shareholders. The latter's option in the face of the offers are limited owing to the threats of delisting. Additionally, if their public shareholding dips below 10 per cent consequent to an open offer, Sebi allows companies to delist, subject only to the condition that they offer to buy out the residual investors' holdings at a price not less than the open offer price. Multinationals have been quick to use this window to buy back their stocks at rock-bottom valuations and delist. This doesn't bode well for small investors or for the capital market.
2. **SUPPRESSED INCOME**: some listed companies have many private limited companies in the promoter's wife's name, in his in-law's name, married daughter's name etc. finished products are sold to private firms that are directly or indirectly owned by the promoters at cost price or even at small loss. Those private firms, in turn, sell the products making huge profits. Thus these listed companies always show segment wise losses and the entire money is going to the promoter's pockets.
3. **DEALINGS IN CASH**: Dealings in cash is another common area of manipulation. Cash sales take place and are not reflected in the books. Then

all purchases and expenses are being fully accounted in the books along with the promoter's personal expenses.

4. FAKE BILLS: the most common practice among corporate is to buy fake bills for a small price, make the payment against these bills by cheque and instead of receiving goods, ask for the money back in cash. This is a common practice among the Marwari business houses. Example they buy bills of Rs 10 cr to 20 cr ostensibly for raw material purchase and pay for it by cheque. The materials never come to the warehouses; instead they get money back in cash, minus a tiny commission for the fake bill. Then later the promoters simply siphon off cash by buying the bills and under-report sales.
5. BROKEN PACTS: another trick by Indian promoters is to announce a joint venture for a new project. After a while, there are reports about differences between the partners. The money invested in the venture is never recovered. It is written off over five or seven years. But it is all planned. The venture is floated precisely to siphon off money by taking away money invested in joint venture. They put in air to be filing a lawsuit against the firm to recover its investment but in reality the money is already taken in cash and written off in investment in its books.
6. INSIDER TRADING: the Securities and exchange board of India regulations, 1992, defines an insider as any person who, is or was connected with the company, and who is reasonably expected to have access to unpublished price- sensitive information about the stock of that particular company, or who has access to such unpublished price sensitive information.

Information that could be price sensitive includes periodical financial results of a company, intended declaration of dividend, issue or buyback of shares, any major expansion plans or execution of new projects, amalgamation, merger, takeover, disposal of the whole or substantial part of the undertaking and any other significant changes in policies, plans or operations of the company. However, insider trading isn't always illegal. Trading by a company insider in its shares is not violation per se and is legal. **What is illegal is the trading by an insider on the basis of unpublished price-sensitive information.**

Working of insider trading

An insider buys the stock (he might also already own it). He then releases price-sensitive information to a small group of people close to him, who buy the stock based on it, and spread the information further. This results in an increase in volumes and prices of the stock. The inside information has now become known to a larger group of people which further pushes up volumes and prices of the stock.

After a certain price has been reached, which the insider knows about, he exits, as do the ones close to him, and the stock's price falls. Those who had inside information are safe while the ordinary retail investor is stuck holding a white elephant as, in many cases, the 'tip' reaches him only when the stock is already on a boil.

The regular investor gets on the bandwagon rather late in the day as he is away from the buzz with no direct connection to the 'real' source. He buys the overvalued stock due to imbalance in the information flow.

While it's common knowledge that insider trading takes place, it is very difficult to prove. Insiders may not trade on their own account. Flow of information is another important factor, but difficult to track. Regulations are in place to prevent this, but the stock price of a company invariably tends to move up or down at least a couple of weeks ahead of any price-sensitive announcement.

In case of ICFI the stock has been on fire since early January 2007. It gained almost 53 per cent in eight trading sessions from Rs 13.45 before the announcement of its 7-per cent stake sale in NSE was made in January 2007.

The stock also gained 30 per cent in 12 sessions before the announcement to appoint Ernst & Young for advising the company on induction of a strategic investor in the company was made in March 2007. From this level, the run up in the stock has been over 210 per cent.

While it is not possible to say that insider trading took place in this case, little else explains the share price movement.

The impact of insider trading on the small investor is negative both from the point of view of their financial interest and also their confidence in the markets. It is extremely detrimental to the growth of a healthy capital market where all participants, big and small, can step in

with confidence of a fair play. In an efficient market, even one share traded on insider trading violates the integrity of the markets.

The first legislative attempt to curb insider trading was in the shape of a disclosure requirement requiring company's directors' shareholdings. Sections 307 and 308 were incorporated in the Companies Act, 1956, and were specifically applicable to directors only. Later on, in 1960, the scope of these sections was widened by making them applicable to managing agents, secretaries and treasurers and managers in the same way as they applied to the directors.

In May 1984, the government of India constituted a high powered committee (Patel Committee) to make a comprehensive review of the functioning of the stock exchanges and to make recommendations to the government. The insider trading regulations underwent a comprehensive change in 2002 in terms of Sebi regulations, 2002, which became effective from February.

RECOMMENDATIONS

The election of the board of directors should be held on the yearly basis because if the directors in a company are working towards the overall benefit of the company including all the stakeholders they should not be afraid of election. This will help to ensure that the decisions being taken in the board meeting is in the benefit of the company as a whole. This might also help to curb the problem of insider trading as all will be kept an eye on.

The investor needs to safeguard himself against the practice of insider trading. Keen observation is needed to remain safe. One needs to be on the alert for strong price movement in the stocks you monitor, increasing volume but no news flow about those stocks or without any apparent improvement in the reported numbers. This could be difficult for those who believe in momentum, and while there is a good chance that they might lose out on some potential gains, the primary aim, however, should be to protect capital and not get stuck at a higher price with limited scope for capital appreciation.

Despite the fact that Sebi regulations on insider trading penalise the person who gives out company information, that is the 'tipper', stock prices have seen unwarranted movements ahead of price-sensitive announcements. While currently there is a vague prohibition against procurement of information, it does not clearly prohibit a 'tipped' from trading based on the information received. Thus harsh penalty imposed on the tipper is required to curb the practice to some extent.

It has been proposed to remove bonus shares and rights shares from the purview of insider trading. However, industry body Ficci has said that Sebi should retain such announcements within the ambit of its insider trading policy as stock prices are sensitive to such news. It was also suggested that monetary penalty be levied on the defaulter rather than criminal penalty as that is more expensive. But the defaulter may not mind paying a sum of money and this might lead to proliferation of the problem.

Currently, there are 24 investor associations registered with the Securities and Exchange Board of India (Sebi)—and they will qualify to get money from the Rs15 crore Investor Protection and Education Fund that it created in July 2007 for “investor education and related activities”. The investor fund has been largely used till now to sponsor investor education camps across the country. But it could now be used for more activist causes. Till

now the country lacked a proper grievance cell to hear and protect the small shareholders in a company. Thus the investors association is a step in this direction.

The fund would be utilized for aiding Sebi-recognized investor associations to undertake legal proceedings in the interest of investors in securities that are listed or proposed to be listed. A lot will depend on how the regulator identifies legal battles worth funding, especially since many investor groups are propelled by political agendas and are rife with vested interests. Thus though this step is good but scrutinizing cases and the agenda of investor groups will be a challenge.

Funding will be considered on a case-to-case basis. Sebi will pick up to 75% of legal fees in these cases. The size of the investor fund will also be increased. Grants and donations from the Union and state governments or other institutions approved by Sebi will be credited to it. Additional investment by Sebi, and the interest or other income from investments made from the original corpus, will also be added to the investor protection fund.

Legal cases fought by investor associations will qualify for Sebi funding only if there are a thousand or more investors affected, or likely to be affected, by issues such as mis-statement in offer document, non-payment of dividend, fraudulent and unfair trade practices or market manipulation. Legal aid will not be provided if the Sebi board is a party in the court case or where it has initiated enforcement action.

Thus according to a source a more effective step will be if India introduces class action law suits, as in the US. A class action suit is one filed by a group of people who are affected by a common issue. In the US, most lawyers charge a fee only if they win class action suits for their clients, unlike the flat fees charged by Indian lawyers irrespective of whether they win or lose a case. The US model provides incentives for lawyers to fight cases where investors cannot pay upfront.

Sebi-approved associations include groups from big cities such as Mumbai, New Delhi, Ahmedabad, Chandigarh and Kolkata. It also includes groups from smaller cities such as Kolhapur, Vijayawada, Bhopal, Cuttack, Puducherry and Aizawl. Delhi itself has 2 investors' associations. But as has been seen people are not interested in joining investor associations. Like the Bombay Shareholders' Association has only 400 members who paid Rs. 2100 for a life membership. Thus more awareness needs to be created of these associations amongst the shareholders.

Investors' helpline is on the lines of investors' associations and any person who has any grievance relating to investment in corporate sector can seek redressal of his grievance by filling the requisite Grievance Form under the appropriate category.

Grievances on this portal have been divided under eleven sub-headings given below:

- Non Receipt of Refund Order/ Allotment Advise related
- Non-Receipt of Dividend
- Non-Receipt of Share certificates/Units after allotment/transfer
- Non receipt of Bond Debentures / Interest / Redemption Amount
- Offer for Rights Issue
- Non-receipt of Investments and returns thereon on Collective Investment Schemes / Plantation Companies
- Non-receipt of Annual Report / AGM Notice / Proxy Form
- Non-registration of Change in Address of Investor
- Non-receipt of Fixed Deposits related amounts
- Demat Grievances
- Miscellaneous (For Grievances not covered under any specific head

Presently, the following grievances are not taken-up by Investor Helpline:

- Disputes between clients and brokers.
- Dispute referred to arbitration through Stock Exchanges.
- Alleged unauthorised operation of Accounts by Depository Participant.
- Grievances relating to companies under winding-up/liquidation.

In Delhi, The Investor Helpline portal is developed by Midas Touch Investors Association under a project sponsored by Investor Education and Protection Fund for providing a platform to the Investor for

- Redressal of Investor Grievance.
- The Portal aims at informing and updating investor about his Rights under Acts like Companies Act, SEBI Act etc. Midas Touch Investors Association proposes to keep on adding investor friendly information on the portal from time to time.
- Midas Touch Investors Association would work as an intermediary between the companies/entities/regulators and Investors in capital market.

- Midas Touch Investors Association would act as an advocacy group for suggesting systemic reforms.

The portal will close complaints after 6 months of filing of the grievance.

But the awareness amongst the shareholders in terms of such helplines available is naive. Thus SEBI needs to create awareness amongst them in order to provide a safe window for their safeguard.

The SEBI can have some guidelines in terms of creating a three tier system for the shareholders. Different shareholder meetings should be held in every district or state whichever where a representative can hold proxy for say 100+ shareholders who can then join at the AGM for voting. The shareholder director should also be elected amongst those representatives through the mechanism of postal ballots, who can then address the needs of the minority shareholders. The information back ways can also be disseminated through the same channel so that the shareholders are made aware of the decisions being taken at the board.

In my view, small shareholder representation is necessary, but only if investor representatives have track records of fighting for investors rights and are part of an accredited investor association. Such minority shareholder representatives will then be accountable to their investor associations and companies would have less scope to influence them or be blackmailed by them.

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