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Enforcement of Corporate Governance in India: Steps Forward

Vikramaditya Khanna*

1. Introduction

The debates related to corporate governance in India have only increased in frequency and importance following the revelation of the Satyam fraud in January 2009 (Kripalani, 2009; Sanyal & Tiwari, 2009; Sukumar, 2009). The Confederation of Indian Industry (CII) and the Institute of Company Secretaries of India (ICSI) have come out with recommendations meant to enhance governance in India and to prevent future frauds (CII Report, 2009; ICSI Report, 2009). Although these recommendations address many areas, one concern that is common to most of these reports is enforcement (KPMG Report, 2008; CII Report, 2009; ICSI Report, 2009). It is generally accepted that consistent and effective enforcement is vital for enhancing governance, encouraging stock market development, and improving firm value (Coffee, 2007; Daines & Jones, 2007; Dharmapala & Khanna, 2010; Eluvangal, 2009; Jackson & Roe, 2009; Khanna, 2010b). In some countries, enforcement is often conducted through a web of government enforcement (e.g. criminal sanctions), private enforcement (e.g. civil suits filed by shareholders), and liability

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against third parties (like accountants for instance). In India however the overwhelming majority of corporate governance enforcement rests with the various arms of the government, with private civil litigation playing effectively no role. Further the general perception is that this government enforcement is insufficient, inefficient, and slow, especially in light of the delays in the Indian legal system (Debroy & Singh, 2009; Khanna, 2010a; National Mission for Delivery of Justice and Legal Reform, 2009). This paper examines corporate governance enforcement in India and explores what kinds of enforcement reforms might be beneficial taking into consideration both the ownership structure of most Indian firms and India's institutional considerations in the legal and judicial sphere.

The primary recommendations made in this paper are that (1) government enforcement can be improved by developing early warning systems (to identify potential governance problems) and by reforming certain parts of the criminal law; (2) building some measure of private enforcement (of which there is effectively none in India) may be beneficial; and (3) enforcement in India should focus on the governance concerns most likely to be prevalent in Indian firms (a majority of which are controlled firms).

This paper begins by examining potential changes to government enforcement. Recent studies have found that government enforcement of corporate and securities law is crucial to various measures of stock market development (Coffee, 2007; Daines & Jones, 2007; Jackson & Roe, 2009). The Securities and Exchange Board of India (SEBI) is the primary regulator of the stock markets in India. It has a broad mandate and has been engaged in an increasing number of enforcement activities (SEBI Annual Report, 2008–09). However it has not really been tested in terms of policing corporate fraud like Satyam, and given SEBI's workload and budgetary considerations it is probably time to consider what additional steps can be taken to make government enforcement more effective. Given the delays in the Indian judicial system it would appear that steps to reduce the need to rely on courts might also be desirable. For instance providing early warning signals to regulators and investors to enable them to initiate some kind of action might prove beneficial. In addition, utilising criminal laws in a targeted manner could prove desirable because it would have a considerable deterrent effect, and would send out messages (or signals) to society about what kinds of conduct are acceptable (Khanna, 1996; Packer, 1968; Shavell, 1985). However criminal law enforcement can be misused and so it is important to address ways in which to constrain such enforcement to ensure that it narrowly targets only the truly culpable, and to reduce the scope for potential corruption and harassment (e.g. by reducing the ability of authorities to arrest directors in a hurry without sufficient proof, by ensuring serious sanctions for filing false reports, etc.) (Hylton & Khanna, 2007; Khanna, 2010a; Parker, 1993).

In addition to changes in government enforcement, building measures of private enforcement would provide some key advantages. In particular the possibility of private parties recovering losses suffered due to fraud is important to encourage private parties to provide enforcement relevant information to the authorities (Landes & Posner, 1975), and to encourage investment and enhance stock market liquidity (Khanna, 2010b). However providing shareholders in India the right to sue would necessitate their involvement with the Indian judicial system which is not an attractive alternative given the delays involved in this route. Another alternative that could be considered is the addition of a provision in the Stock Exchange Listing Agreement (SELA) which would say (in effect) that all alleged violations of the law that lead to losses to shareholders are to be addressed in binding arbitral proceedings unless specifically agreed to otherwise. Arbitration would then become the default course of action for shareholders unless both the firm and the shareholders explicitly agree to opt out of arbitration. As a supplement to arbitration, one might consider providing small rewards to non-shareholder parties who provide enforcement relevant information to the authorities.

Finally when it comes to the matter of enforcement there needs to be some degree of discretion in deciding what enforcement actions to bring, who to pursue for liability and so forth, regardless of what enforcement system is in place. One example of guiding enforcement discretion is found in the United States where government authorities often provide guidance on how their enforcement discretion might be used (Thomson Memo, 2003). The key would be to make the application of discretion transparent and rational. In the context of corporate and securities laws it would be crucial to focus on the kinds of violations that would be of concern to India given the controlled ownership structure of the majority of Indian firms. Thus spending enforcement resources on monitoring corporate control contests would appear to be unnecessary (in the Indian context) as most Indian firms do not have control that is contestable, and spending resources on calculating or disclosing executive compensation need not be a primary goal because managerial expropriation of firm value through compensation schemes is a concern generally associated with dispersely held firms not controlled ones (Bebchuk & Hamdani, 2009; Khanna, 2009a). However resources focused on monitoring *tunnelling* activities and related-party transactions could produce much greater marginal benefits, as could resources focused on the selection of independent directors (Bertrand et al., 2002). Of course if the ownership structure of Indian firms changes over time then so would the enforcement focus, but this is a *non sequitur*.

We provide a broad overview of the enforcement structure for corporate and securities laws in India in Section 2. Although government enforcement represents the overwhelming majority of enforcement activity in India, it is informative to examine how the enforcement is structured and who the authorities empowered to act are. Section 3 explores some of the theoretical issues related to enforcement that are relevant to the current inquiry. Section 4 discusses how the issues raised in the preceding sections are affected by the institutional and ownership contexts in India, and proposes reforms to the enforcement system in India. We conclude the discussion in Section 5.

2. Enforcement structure for corporate and securities laws in India

Law and enforcement are important for the growth of stock markets for a number of reasons. Investors tend to invest in firms and jurisdictions where they perceive attractive returns and sufficient protections for their investments that make them feel secure enough to invest their capital in firms located far away from them (Daines & Jones, 2007; Jackson & Roe, 2009; Khanna, 2010b; La Porta et al., 2006). This security could be obtained in some measure through private ordering—reputational mechanisms, reliable intermediaries, etc.—as well as through the law (Coffee, 2001). Thus one way in which the law could play an important role is by providing investors with some protections against undesirable outcomes. Of course, some firms and executives may comply with the law voluntarily, but some might not. It is in the latter situation that the necessity and relevance of enforcement becomes apparent. In particular, enforcement can provide signals about government attitudes toward acceptable governance standards and what areas are likely to witness the bulk of enforcement activity (Milhaupt & Pistor, 2008), assurances to investors about the credibility of firm disclosures by imposing sanctions on misleading or inaccurate disclosures (Daines & Jones, 2007), assurances to investors about the credibility of the measures meant to protect investors' property rights against expropriation by punishing such expropriation (La Porta et al., 2006), and assurances to investors that they can have their grievances addressed in some efficacious manner (Coffee, 2007; Jackson & Roe, 2009; Khanna 2010b; Roe & Siegel, 2009).[1] All of these effects would encourage smaller investors to invest in firms, leading to better stock market development.[2]

In this context it becomes important to consider the various kinds of enforcement methods that might be used to provide investors with the protections they desire.[3] At a conceptual level there are at least two possibilities. First, there is enforcement by the government via civil penalties or criminal sanctions (i.e. public enforcement). And then there is enforcement by the victims of wrongdoing (or private parties) to recover damages or obtain an injunction by civil suits (i.e. private enforcement).

Public enforcement in India

Corporate and securities laws in India are enforced through the many different arms of the government. We provide an overview of the four primary arms of the government that enforce the laws in this area.

Securities and Exchange Board of India

SEBI enforces matters arising under the Securities & Contracts (Regulation) Act 1956 (SCRA, 1956) and the Securities & Exchange Board of India Act 1992 (SEBI Act, 1992), as well as the regulations and rules promulgated under these Acts.[4] SEBI's decisions can generally be appealed in the first instance to the Securities Appellate Tribunal (SAT), the High Court, and then potentially to the Supreme Court of India.[5] Both the SCRA (1956) and the SEBI Act (1992) contain provisions and regulations that are relevant to corporate governance. Perhaps the most important is Section 23E of the SCRA (1956) which states that a violation of the Stock Exchange Listing Agreement (SELA) can result in severe financial and criminal penalties for the directors and the firms involved. The SELA contains Clause 49 which is the watershed corporate governance provision in India. Violations of Clause 49 can be enforced by SEBI under Section 23E of the SCRA.[6] The crucial matter is then whether these provisions have been enforced.

Although it is well known that a number of firms are not complying with the provisions of Clause 49 (Balasubramaniam et al., 2010), the first (and to date, the only) time SEBI initiated investigation proceedings was in September 2007 (SEBI Press Release, 2007). This was more than seven years after the initial enactment of Clause 49, and nearly two years after all firms which were subject to Clause 49 were to have complied with its provisions. The proceedings were primarily initiated against firms owned by the Indian government, and to date no sanctions have been imposed.[7]

In addition to Clause 49, there are a number of other SEBI regulations that could address governance issues, such as insider trading, and other forms of unfair trading practices;[8] the failure of a firm to address investor grievances sent to the firm by SEBI or a stock exchange;[9] and violations of certain provisions in the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, as amended in 2010 ("Takeover Code").[10]

SEBI has brought enforcement actions under some of these rules, but often the issues are not at the core of governance concerns, but are at the periphery (SEBI Annual Report, 2008–09). However the presence of active SEBI enforcement in primarily noncore governance areas suggests that SEBI could be a useful source of enforcement and could provide credible deterrence related to governance issues if it became more active in enforcement.

Ministry of Company Affairs

Although SEBI is the primary enforcement agency for violations of securities laws, the primary agency for the investigation of company laws is the Ministry of Company Affairs (Ministry of Company Affairs Annual Report, 2005). The ministry acts mainly through its investigations divisions, serious fraud investigation office (SFIO), regional directors, and registrars of companies. The investigative authority is broad, but the provisions for which cases can be brought are limited to those mentioned in this paper, especially the criminal provisions.

Company Law Board

Another important enforcement arm of the government is the Company Law Board (CLB) (which is supposed to be replaced by the National Company Law Tribunal (NCLT)).[11] The governance related matters which the CLB primarily deals with are claims of oppression and mismanagement under Sections 397 to 399 of the Indian Companies Act 1956 (ICA, 1956). These sections are not often seen as important remedies because the most common remedy available is an injunction, and also because the CLB has the power to insulate directors from liability under Section 633 of the ICA (1956) (Ramaiya, 2006). Moreover the CLB has not often been very fast, and the delays would reduce any potential gain to shareholders from such actions.

Reserve Bank of India

The Reserve Bank of India (RBI) can regulate certain matters under the Foreign Exchange Management Act 2000 (FEMA, 2000) that can have an impact on governance.[12] As these matters are generally not considered as core governance concerns, we will not discuss the RBI's enforcement role in any great detail.[13]

Criminal actions under the Indian Penal Code

The Indian Penal Code (IPC) provides a number of provisions under which governance related matters can be addressed. These include criminal breach of trust (section 406) and cheating (section 420).[14] Although these provisions do not target core governance concerns, they are sometimes used to address these concerns (Khanna & Mathew, 2010). However conviction rates are not terribly high (a concern found in many areas of the IPC and related criminal provisions) and hence the deterrent effect of these provisions is likely to be attenuated (Debroy & Singh, 2009; Khanna 2010a). Nonetheless the power to arrest is ubiquitous even if convictions are not. This particular equilibrium (easy arrest and difficult convictions) is troubling on multiple levels and is a matter that needs to be addressed before criminal laws can be used effectively in this area (Khanna 2010a; Khanna & Mathew 2010).

Private enforcement: Common Law

There is essentially no private enforcement existent in India for corporate governance related matters.[15] One of the critical impediments shareholders face are provisions in the relevant Securities Laws that prohibit civil courts in India from entertaining suits on a matter over which SEBI is empowered to act.[16] Nonetheless assuming that the securities laws did not contain such prohibitions, we discuss in the next few paragraphs some of the potential actions where private enforcement could arise to highlight how these potential actions are essentially not available in India for governance related matters.

Private enforcement in India could (in theory) arise through potential application of the Common Law, the possibility of a statutory fraud claim under Section 17 of the Indian Contract Act 1872, and potential claims for misrepresentation in a prospectus under Section 62 of the ICA (1956). In each of these areas the chances for shareholder recovery are essentially nil and the delays in the Indian judicial system would only serve to minimise any potential gains.

Under the Common Law one possible claim would be the tort of Deceit. However this has a number of requirements that make its availability rather limited (Ramaiya, 2006). These include (1) the existence of a fraudulent misrepresentation; (2) the requirement that the representation relates to a material fact; and (3) the stipulation that the plaintiff received the shares directly from the company by allotment.

The third requirement essentially means that purchasers in the secondary market can make no claims unless the misrepresentation was made to them directly (e.g. face to face) (Ramaiya, 2006). In the United States this is referred to as the individual reliance requirement, which makes recovery extremely difficult for most shareholders who would rarely be able to show they explicitly relied upon the misrepresentation in a face-to-face transaction (Loss et al., 2010). Consequently in the United States the *fraud on the market* presumption helps to alleviate concerns with proving individual reliance by presuming that share prices reflected the misrepresentation and that individual investors relied on those share prices in engaging in their transactions (Choi & Pritchard, 2008). However, India has not yet adopted this presumption for the tort of Deceit. In addition judicial delays would further trivialise any (highly unlikely) recovery that might be available.[17]

Similarly the statutory remedy for fraud under the Indian Contract Act 1872 comes with a number of requirements that makes its usefulness for governance issues rather limited. There is a requirement that the fraud be engaged in by a party to the contract (or its agent) which is rarely the case for secondary market purchasers (Singh, 2004).[18] Further, the individual reliance requirement is also a sizeable impediment (Singh, 2004).[19]

Overall, corporate and securities law enforcement in India is public enforcement with essentially no private enforcement, which is further hampered by the delays in the Indian judicial system. Moreover public enforcement has shown a tendency to focus on issues related to market structure and process (e.g. settlement days) rather than more standard corporate governance concerns.[20] The limited nature of enforcement in this area would make it more difficult for dispersely held firms to develop in India because with weak protections, investors may need to rely on setting up control blocks and other methods to secure their interests (Coffee, 2001; Roe, 1994).

We find that many of the surveys of corporate practices in India note enforcement as one (often, the most) critical concern for corporate governance in India. These studies suggest that the respondents felt that the penalties were too low, and that there was weak oversight and monitoring. The same studies also find that many respondents would prefer to see greater protection of minority shareholders, along with more evaluations of whether the board is performing well, granting independent directors more power, and conducting more board sessions without the management present (CII Report, 2009; ICSI Report, 2009; KPMG Report, 2008).

This overview of the enforcement structure of corporate and securities laws in India was meant to provide a sense of the basic approach in India which is public enforcement with essentially no private enforcement. The question is whether this is desirable. To explore this question, Section 3 describes the theory on optimal enforcement, and in Section 4 we consider how the insights from Section 3 may apply to the Indian context.

3. Enforcement theory: An overview

In exploring optimal enforcement theory we focus on those issues that appear to have the greatest relevance to India, namely the optimal balance between public and private enforcement, and the optimal mix of sanctions (monetary and non-monetary). Table 1 provides an overview of the broadest categories of enforcement options. The rest of this Section summarises the vast literature on the economics of enforcement and what factors are relevant in making a choice from among the enforcement options.

Table 1: Enforcement options

Issues	Options
Identity of enforcing entity	• Government • Private party
Type of sanction	• Monetary • Non-monetary • Preventive ex ante

Public enforcement, or private enforcement, or a combination of both?

There are at least two rationales for having private enforcement, one related to enhancing enforcement, and the other to potentially enhancing stock market development by deepening liquidity. In terms of enforcement rationales, the key advantage of private enforcement is that the victims of wrongdoing probably possess information on the wrongdoing that public enforcement agents cannot access as easily as the victims (Landes & Posner, 1975). For example, victims often possess knowledge about who injured them and how. Such information might be difficult or expensive for public authorities to access. Private suits for damages provide incentives for victims to come forward with their information, increasing the chances that the wrongdoer will be sanctioned and thereby increasing deterrence.[21]

Access to the information that private parties have can be obtained in multiple ways. Private parties could be allowed to sue to recover damages. Such a method requires that private parties approach the courts for damage recovery, and subjects them to the cost and delay of civil litigation. One alternative to private litigation is to provide private parties with rewards (e.g. bounties) when they provide enforcement relevant information to public enforcement agents (Polinsky, 1980). This method allows for information to be provided, but does raise issues regarding the amount of the bounty, how many people are entitled to it, and how to deal with false information (Fitzner et al., 2007; Rich, 2008).[22] Rewards work particularly well when the information is provided *before* the public enforcer would have discovered it anyway, and when there are not many private parties all expending resources to be the first to provide that information to public enforcement. In other words, we may not want to create an incentive for people to spend great amounts of time and resources ferreting out such information if it can be obtained in simpler, less expensive ways (Kaplow & Shavell, 1994; Polinsky, 1980).

Private enforcement might also be desirable because it provides compensation to victims of governance wrongdoing (assuming no insurance is available to victims), and this would help in stock market development by attracting more investors to invest in Indian firms. This is in essence an argument that provisions for compensation for losses suffered should increase the liquidity of the markets (Choi & Pritchard, 2008; Khanna, 2010b). This argument appears to have some force—if investors think that they cannot recover losses suffered due to fraud (or would have difficulty in doing so, or would have to wait a long time to do so), then one would expect investors to be reluctant to invest. This however oversimplifies the concern.

The risk of fraud is another type of risk that investors face which might (in theory) be addressed much the same way as some other risks are handled—for instance, through diversification. However diversification cannot easily reduce any systemic risk associated with fraud. If a particular market is perceived to be rife with fraud then shareholders might simply avoid investing in that market which would hamper stock market development (Akerlof, 1970; Choi & Pritchard, 2008). Further if diversification is expensive then at the margin that too would hamper stock market development by reducing liquidity.[23]

Thus both for enforcement reasons and liquidity reasons it would be desirable to provide for some kind of private enforcement. Whether this takes the form of full private civil litigation, something moderately less than that, or rewards will be discussed in detail in Section 4.

Setting Sanctions

Another critical enforcement matter is related to what kinds of sanctions should be used and when. There has been considerable research on this topic. The discussion begins with Becker's (1968) seminal article which starts with the notion that people consider the expected sanctions (and gains) when acting, not just the nominal sanction. An expected sanction is the actual sanction multiplied by the likelihood of its imposition. For example, if the penalty for insider trading is \$100,000 and the likelihood of its imposition is 50% then the expected penalty is \$50,000. To deter someone from engaging in a harmful activity the expected sanction needs to be set equal to or slightly higher than the harm caused. Thus $h = f \, x \, p$, where h = harm; f = fine (or sanction); and p = probability of imposition of that sanction. The expected sanction is then $f \times p$.

Thus, if the harm is $1 million and the likelihood of imposition is 20% then the fine (or sanction) needs to be set at $5 million to generate an expected sanction of $1 million. If the actual sanction is set at less than $5 million then the potential wrongdoer stands to gain by engaging in the harmful activity. The probability of imposition is sensitive to enforcement expenditures—the more the amount spent on enforcement, the higher the probability of imposing a sanction. Thus we can obtain the same expected sanction by increasing enforcement expenditure and reducing the magnitude of the actual sanction, or by decreasing enforcement expenditure and increasing the magnitude of the actual sanction. For monetary sanctions the general idea is that increasing the sanction does not increase social costs, but increasing enforcement expenditures does.[24] Thus the preference is to reduce enforcement expenditures and increase the actual sanction.

However at some point, an upper limit will be reached on the actual monetary sanction that can be imposed (e.g. the potential wrongdoer's wealth or some threshold dictated by political, social or moral considerations). In order to achieve more deterrence it may be necessary to either increase enforcement expenditure or use non-monetary sanctions (e.g. imprisonment). Non-monetary sanctions do have social costs (e.g. costs of maintaining prisons, denying prisoners their liberty) that need to be balanced against the benefits of increased deterrence and compared to the net gains of increased enforcement expenditure (Shavell, 1985). Thus where monetary sanctions cannot be increased any further we need to use non-monetary sanctions or increase enforcement or a mix of both.

The need for non-monetary sanctions increases with the harm caused by the wrongdoing because it is then more likely that monetary sanctions will not be enough to cover the losses caused. Thus, the general sense is that non-monetary sanctions should be reserved for those activities that are more harmful.[25]

However it is possible that the harm caused by certain activities is so large that even the presence of non-monetary sanctions with increased enforcement may not result in the desired level of deterrence. In such areas it may be better not to rely exclusively on liability measures (*ex post* measures) and to bring preventive (*ex ante*) measures into the mix (Shavell, 1984).[26] In the following section, we begin our exploration of how these insights from the enforcement literature map on to the institutional and ownership contexts in India.

4. Contextualising enforcement of corporate governance in India

There are at least two issues we need to consider while examining the situation in India. First we need to contextualise whatever we do to address the kinds of corporate governance problems that arise in India. Second we need to contextualise the responses to the Indian judicial and regulatory landscape. There are other issues that would also possibly need to be considered (e.g. budgetary limits, political constraints), but we limit our inquiry to these two issues.

Governance context in India

Most of the publicly traded Indian firms are controlled by a group of shareholders, a family group, foreign entities, or the Indian government. Taking this into consideration, an enforcement policy should inquire into whether private enforcement would be as useful here as in dispersely held firms, whether one should consider criminal penalties in this context, and on what kinds of activities enforcement (public or private) should focus.

There are reasons to believe that private enforcement is likely to be quite viable in the Indian context. If obtaining enforcement relevant information is a plausible rationale for granting shareholders in dispersely held firms the power to initiate a civil suit, then that rationale should be even stronger for minority shareholders in controlled firms, since dispersed shareholders are less likely to have enforcement relevant information. The interests of the small shareholders in a dispersely held firm are such that it is probably not worth their while to monitor the firm closely. This collective action problem is a common concern in dispersely held firms. However in controlled firms minority shareholders often have more shares than the average shareholder in a dispersely held firm, and hence would have greater incentive to monitor behaviour. Moreover it is easier to know who to monitor in a controlled firm—the controller—rather than in a dispersely held firm where the responsibility for behaviour may be more diffuse.[27]

Given the increased monitoring by minority shareholders, *non-shareholder parties* might not be expected to have additional enforcement relevant information that the shareholders do not already possess. This would reduce the desirability of a reward system. However it does not eradicate this need completely because some kinds of fraud are such that they require the assistance of third parties, and in such cases giving rewards to those who can help to break up the fraud would help. In addition some controlled firms in India may have many small shareholders (rather than minority blockholders) who may not monitor the firm that closely and for such firms a reward system may be worth considering.[28]

Further the liquidity enhancing features of private enforcement seem similar across dispersely held and controlled firms. Taking this point into account along with the arguments presented above would suggest that private enforcement could be quite beneficial in the context of controlled firms.

Another issue to consider is whether the kinds of harms are such that we might need criminal sanctions or early warning signals for controlled firms. Securities fraud and governance violations can generate very large losses (as in the case of the Enron scandal and the Satyam fraud), and this suggests that the availability of criminal sanctions and early warning signals (or other *ex ante* measures) would be desirable. Moreover where an attempt is being made to change (in some measure) the attitudes of those in control (of firms) criminal laws can play a role in sending a message/signal (Khanna, 1996; Packer, 1968). These seem to be good enough reasons to allow some criminal liability and to consider early warning signals.

A final point worth mentioning is one that has been raised many times in the extant literature on comparative corporate governance. The governance at controlled firms raises relatively different concerns than the governance at dispersely held firms. This suggests that the law and enforcement discretion should attend to the concerns that are most likely to be present in controlled firms (tunnelling risks, related-party transactions, for instance) rather than to those that surround dispersely held firms (like executive compensation, regulation of corporate control contests, etc.) (Bebchuk & Hamdani, 2009; Khanna, 2009a). This targeting or fine tuning of enforcement activity is discussed towards the end of this section after laying out how private and public enforcement can be enhanced in India given its institutional constraints.

Enforcement in the Indian Institutional Context

The analysis presented so far suggests that building private enforcement, using criminal laws more effectively, and developing early warning signals might prove beneficial in India. However these suggestions need to be tempered by the reality of the Indian institutional (and judicial) context.

Increasing private enforcement by relying on civil suits might be desirable in general, but given the lengthy delays in the Indian judicial system, any judgement would be so far in the future as to lose any real sense of recovery. The delays in the Indian judicial system are matters with which the Indian government and the parties involved in litigation have struggled for quite some time (Law Commission of India Report, 2008; National Mission for Delivery of Justice and Legal Reform, 2009). Until the judicial process is rid of these delays, we should consider alternatives to increasing civil liability through courts in India.

There are a number of options that could be pursued. A provision could be made for shareholder recovery through arbitral proceedings. The Stock Exchange Listing Agreement (SELA) could be amended by SEBI to require that firms and shareholders agree that when shareholders purchase shares listed on one of the Indian exchanges they will have all governance and investor disputes determined by arbitration. This would be in addition to any enforcement SEBI or the other arms of the government might pursue.[29]

Arbitration offers a number of advantages over recovery through civil litigation (Haydock, 2000; Hylton, 2000; Shavell, 1995). First of all the procedures are more streamlined than in courts. Secondly arbitrators often have more specialised knowledge in the matter under dispute, whereas courts are usually composed of judges with less specialised knowledge. Additionally arbitration is not subject to the same delays as judicial decisions. Thus one option for private enforcement that does not rely on the courts is to have the arbitration provision made a part of the SELA. If some amount of flexibility is required, arbitration could be made the default provision in the SELA unless the firm and its shareholders contract around it.[30] Arbitration provisions are already available for firms listed on the Novo Mercado in Brazil and for firms in Delaware, and are required for firms domiciled in China which issue stock overseas; in fact, some firms in India offer arbitration as a method of resolving grievances with shareholders (Balasubramaniam et al., 2010 (in the context of India); Howson, 2008 (in the context of China); Pileggi, 2010 (in the context of Delaware); Millstein, 2005 (in the context of Brazil)).

Another method of enhancing private enforcement (which would not require arbitration) is to grant rewards to individuals who provide enforcement relevant information to the authorities. Although a well designed reward structure can benefit enforcement (Fitzner et al., 2007; Polinsky, 1980; Rich 2008), it does not by itself do much to address the liquidity based reasons for the provision of more direct compensation to shareholders (e.g. via arbitration). This is because the reward is given only to those people (shareholder and non-shareholder) who actually provided enforcement relevant information and not all shareholders who might be entitled to recovery via arbitral proceedings. Thus a reward scheme can supplement civil litigation or arbitration but not completely supplant it, at least for purposes of enhancing liquidity.[31]

However as a supplement, a rewards system could prove useful for extracting information from non-victim parties, for example from executives at the firm who do not own shares but possess information about wrongdoing. Some measures would need to be put in place to prevent misuse of the reward system as well as to reduce wasteful duplicative efforts by people to claim rewards (Fitzner et al., 2007; Polinsky, 1980; Rich, 2008).

Yet another option might be to encourage Stock Exchange enforcement. There is some measure of this in the United States where the Stock Exchanges have an enforcement (self-enforcement) role (Pritchard 2003, Mahoney 1997). Generally, exchanges are interested in enhancing trading volume and because investors are concerned about fraud one might expect exchanges to have strong incentives to reduce fraud to encourage more people to trade on their exchange. This suggests that delegating enforcement, in some measure, to exchanges could be beneficial.

However, for fraud or wrongdoing that is unlikely to reduce trading volume in the short run (e.g., "cornering" a market, self-dealing) exchanges incentives may not be optimal (Pritchard 2003, Pirrong 1995). Further, if there is a sense that the exchange may suffer from conflicts of interest, be beholden to certain large issuers, or be facilitating suppression of competition then the exchange's incentives may not be optimal (Pritchard 2003). Finally, even if exchange enforcement were a valuable enforcement option along with the others noted earlier, we should still keep in mind that it does not itself directly address liquidity concerns unless it provides for some compensation to investors.

Criminal Liability in the Indian Institutional Context

As was discussed earlier, criminal liability may be a useful supplement in cases of securities fraud and governance violations. Moreover the delays in the Indian judicial system for civil cases means that the expected sanction tends to become smaller. This is because the present value of a judgement far in the future is more severely discounted by litigants than a judgement closer to the present (to reflect the time value of money). The lower expected sanctions raise the need to increase the actual sanction (e.g., use a criminal sanction). However, these same delays also lead us to be careful in using the criminal sanction. Such delays contribute to the rather low conviction rate in India for criminal cases. It appears that the long wait for a hearing can lead to witnesses' memories fading, evidence getting contaminated, and documents getting lost or destroyed.[32]

A low conviction rate makes the criminal sanction less useful both as a deterrent and as a message sending device. Failure to convict suggests (rightly or wrongly) that the government does not take the wrongdoing seriously. Moreover low conviction rates can make corruption easier—if conviction rates are low (and the enforcement authorities are not penalised for such low rates) then it becomes easier to arrest someone and dismiss the matter in exchange for a monetary payment or other benefits because convictions would not be expected as a general matter (Hylton & Khanna, 2007; Khanna, 2010a). If there are high conviction rates, then when someone is arrested the dismissal of the case would be likely to invite greater scrutiny because a dismissal would be an unusual event. The threat of greater scrutiny is likely to deter at least some people from dismissing a suit in exchange for payment.

If the standard to effectuate an arrest is quite low, it would contribute to generating a lower conviction rate and creating more scope for corruption to flourish, and this would also build up scepticism towards law enforcement. At present, criminal enforcement in India suffers both from low conviction rates and fairly quick arrests (Khanna, 2010a).

Although this is not an ideal forum to discuss reforms to the Indian criminal justice system, it does seem that greater scrutiny on arrests would be beneficial both because it would reduce the risk of being falsely arrested, and because such restrictions would reduce the number of people going through criminal proceedings (which should then speed up the process). The threat of criminal arrest and sanctions against tangentially connected independent directors are likely to help corruption flourish and deter qualified people from serving as directors.

In order to address these concerns criminal laws would need to be used sparingly and only against those who act in a clearly culpable manner, and the authority of the police to arrest hastily without compelling proof would need to be restricted. It would be worthwhile to consider locating the power to arrest for certain corporate offenses with another arm of the government, such as the Serious Fraud Investigation Office (SFIO) or the Central Bureau of Investigation (CBI). Although no agency is perfect, these offices are generally perceived to operate with a high degree of professionalism. In addition to limits on the power to arrest, we should consider imposing sanctions (and perhaps increasing them) for filing false reports with the police. Steps to constrain arrests and also to sanction people for providing false reports seem to be in the offing (Venkatesan, 2010).

Early Warning System

Even with these changes in place it could be that certain kinds of corporate and securities wrongdoing are so difficult to detect and would cause so much harm that we would prefer to prevent them ex ante rather than deter them ex post. Early warning systems may prove particularly valuable in India given the delays in other methods of enforcement. With such warnings, enforcement authorities and also perhaps investors can take their own protective or investigative steps and thereby interdict wrongdoing at an earlier stage so that the loss suffered is smaller and the need for large sanctions is reduced. The key lies in identifying early warning signals that can be operationalised (surveillance systems should be able to pick up these signs) and are useful to interdict wrongdoing.

Table 2 lists some suggested early warning signals that could be considered. The list is not meant to be exhaustive; it is indicative and is meant as a starting point for discussion.

Table 2: Proposed list of possible early warning signals

Early Warning Signals
Related-party transactions exceeding 5% of gross sales
Resignations of several directors
Off balance sheet transactions
Auditor change within 5 years
Decisions to withdraw an offering for equity or bonds
Restatement of results
Sudden trading volume changes by insiders
Promoters pledging shares
Sudden changes in business model(s) even without changes in profits preceding it

These factors can trigger alerts to enforcement authorities and perhaps the investing public so that the relevant audience can pursue it as they choose. Also these signals should influence how authorities direct their enforcement efforts in some manner.

Targeting Enforcement Discretion?

It would seem appropriate to guide enforcement discretion towards the major concerns in India at present and in the foreseeable future. The law and enforcement discretion should attend to the concerns most likely to be found in controlled firms (e.g. *tunnelling* risks) rather than those that surround dispersely held firms (e.g. executive compensation, regulation of corporate control contests). For the Indian situation in particular, enforcement should focus on self-dealing, related-party transactions, *freezeout* mergers, rules on veto rights, rules on nomination and selection of directors, rules on connections between controllers and directors, and rules related to separating cash flow from voting rights (e.g., pyramid structure, cross-ownership structures, dual class structures) (Bebchuk & Hamdani, 2009; Khanna, 2009a, 2009b). Matters such as executive compensation, control contests, rules examining connections between management and directors, and shareholder voting procedures (e.g. proxy voting) may be of greater importance to dispersely held firms, which are the minority in India (Bebchuk & Hamdani, 2009; Khanna, 2009a). With this additional targeting of enforcement discretion greater marginal benefits can be expected from the use of enforcement resources.

5. Conclusion

The efficacious enforcement of corporate and securities laws is an important factor in maintaining the health of capital markets. There is a general sense of dissatisfaction regarding the current enforcement situation in India. Given the tumult in the global financial markets and the frauds at Satyam and Nagarjuna Finance, this seems to be an appropriate time to consider the law and enforcement apparatus in India to enable Indian securities markets to continue to grow.

This paper began by providing an overview of India's current corporate and securities laws that address corporate governance concerns. The vast majority of enforcement in India occurs via various arms of the government, with essentially no private enforcement.

To determine whether this situation is desirable, we explored the literature on the economics of law enforcement. The literature suggests that in the corporate and securities area it would be beneficial to build private enforcement of some kind, to utilise early warning systems, and to provide for some degree of highly targeted reliance on criminal sanctions. This is because victims of wrongdoing may have information relevant for enforcement, and allowing them to bring private enforcement actions provides them with an incentive to come forward with that information. In addition prohibiting private enforcement could hamper the overall liquidity of the securities markets by causing investors to stay away from investing in markets where they cannot obtain compensation for fraud related losses (and where fraud seems to be a non-trivial possibility). Further the harm caused by governance concerns and securities fraud can be quite large and the optimal fine needed for deterrence may exceed the available assets of the defendants. Consequently the desirable sanctions are likely to include prison. Finally given the size of the likely harm from wrongdoing and the difficulty of designing a sanction large enough to deter it, we would be inclined to consider early warning signals that can be used to interdict the wrong before it causes harm that is difficult to remedy.

Although all these potential improvements are in theory desirable, they need to be operationalised within the context of the institutional and other constraints found in India. The one key constraint is that the Indian judicial system does not move quickly enough to make new private civil enforcement via the courts a useful supplement. We suggest making arbitration a default term in all public company share purchases in India (as part of the SELA). This would help to ameliorate concerns regarding the speed of justice delivery in India. Non-victims may have enforcement relevant information, and they should be provided with incentives to come forward to SEBI with that information. One option would be to give a small reward to those parties providing enforcement relevant information who do not bring their own suits or arbitration proceedings (or who forgo such proceedings). Stock exchange enforcement in some measure should also be explored.

Another important constraint is that the criminal process is also quite slow, with quick arrests yet low conviction rates (when compared to other nations). This imbalance suggests the need for greater caution in using the power to arrest; the judicial process also needs to be speeded up. The latter is more difficult to achieve compared to the former. Therefore we suggest that the power to arrest for corporate and securities laws related issues should either be restricted or that power should be vested in specific authorities.

Finally we provide a list of potential early warning signals which SEBI and others (shareholders, and the media perhaps) could consider. Through such measures it would be possible to reign in corporate wrongdoing before it rises to a scale which becomes difficult to address.

All these measures need to be adjusted to focus on the kinds of governance concerns relevant to the Indian situation (e.g. related-party transactions, concerns associated with controlling shareholders). Adopting these steps along with other measures may help to enhance enforcement in India and thereby strengthen India's securities markets further.

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Notes

[1] For a broader discussion of how these factors interact in the development of active stock markets in India, see Khanna (2010b). For a discussion of important conceptual issues related to corporate law see Kraakman, et al (2009).

[2] Although this suggests that law and enforcement are important, one might be skeptical given the stock market growth witnessed in many countries (including India) where even after enacting corporate law reforms, there has been little enforcement. This pattern of law enactment followed by little enforcement with initial stock market growth usually exists for a very short time and for a variety of specific reasons which are explored in detail in Coffee (2001) and Khanna (2010b). However for stock market growth to continue and be sustainable law enforcement needs to start playing its role effectively.

[3] As the focus of research in this area turns to enforcement, scholars have begun to examine what aspects of enforcement matter most. However whichever features of enforcement matter most, it seems clear that those countries with better enforcement (however measured) tend to have more developed stock markets (Jackson & Roe, 2009). The question is why? There are many potential explanations—better respect for the law, political considerations, and so forth. A very likely explanation is that countries with more developed stock markets have better enforcement because the players in the market lobby for it. Under this view enforcement and stock market development have a much more bi-directional relationship, which is what is suggested by the historical evidence from the US and the UK (Coffee, 2001; Khanna, 2010b).

[4] There are other Acts that also provide the basis for regulation in the corporate governance sphere, but they are not as critical to the current discussion, and will be mentioned only in passing.

[5] See Sections 15T, 15U and 15Z of the SEBI Act (1992).

[6] Violations of Clause 49 can also lead to de-listing, but that has yet to happen in India. Clause 49 requires the inclusion of independent directors on corporate boards, defines independence (although with amendments over the years), and lays out some specific duties and obligations of the independent directors.

[7] To date, only 3 of these proceedings have been resolved (leading to no sanctions) (SEBI Press Release, 2007).

[8] See Sections 12A and 15G of the SEBI Act (1992), and Sections 3 and 4 of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations 2003.

[9] See Section 23C of the SCRA (1956), and Section 15C of the SEBI Act (1992).

[10] See Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, as amended in 2010 ("Takeover Code") Sections 45(5) and 45(6).

[11] For details, see Companies Amendment Act 2002; Union of India v. R. Gandhi, in the Supreme Court of India Civil Appeal No. 3067 of 2004 & Civil Appeal No. 3717 of 2005, May 11, 2010.

[12] For details, see http://www.rbi.org.in/scripts/Fema.aspx

[13] Similar comments may apply to regulators of other financial sector entities like insurance, pensions, etc.

[14] For details, see Tristar Consultants v. Vcustomer Services, AIR 2007 Delhi 157; Nanalal Zaver v. Bombay Life Assurance, AIR 1950 SC 172.

[15] For Satyam shareholders in India, their attempts to obtain monetary recovery from the National Consumer Disputes Redressal Commission (NCDRC) were rebuffed by the NCDRC on the grounds that it does not have the infrastructure to address this matter, and other government bodies (e.g. criminal authorities) are addressing it. The Supreme Court of India refused to overturn this outcome. (For details, see Midas Touch Investors Association v. M/S Satyam Computer Services Ltd. & Ors, Civil Appeal No. 4786 of 2009, in the Supreme Court of India, Aug. 10, 2009.) The Satyam fraud led to class actions in the United States as well; the outcome of these cases is pending as of date.

[16] See Sections 15Y, 20A and SEBI Act (1992), and 22E of SCRA (1956).

[17] Another conceptual possibility for private action is breach of fiduciary duties, but this too has limited significance. One reason is that these duties largely apply to directors not controlling shareholders in India and are very difficult to enforce (Varottil, 2009).

[18] For secondary market purchasers the parties are the shareholder who sells the shares and the new shareholder who buys them. These shareholders would not have engaged in the fraud; rather the firm, perhaps some executives, etc. would have been responsible.

[19] Section 62 of the ICA (1956) would provide no recovery because it requires the misrepresentation to be in a prospectus. Other matters that also impede shareholder suits are the absence of contingency fees which makes it difficult for smaller shareholders to find it worthwhile to bring suit, and the absence of a class action mechanism to aggregate shareholders claims making it financially unappealing to bring civil suits. The reforms proposed in the Companies Bill 2009 related to class actions (Section 216 of the Bill) do not substantially change the position for shareholders because the reforms allow for injunctive remedies not damages.

[20] After the Satyam and Nagarjuna Finance scandals, the perceived risk of potential arrest and the criminal liability for directors appears to have increased (Khanna & Mathew, 2010).

[21] Not every wrongdoing results in victims who can identify wrongdoers (e.g. environmental pollution), and in such instances private enforcement may have more limited value (Landes & Posner, 1975). Moreover public enforcement might be more useful when the detection of wrongdoing requires the development of information systems to monitor

activity (like nationwide databases) which might not be worthwhile for private parties to develop. Private parties might not have the incentive to develop such systems due to standard free riding concerns. Further force may be required to capture potential wrongdoers, and the government would prefer, for a variety of reasons, to be the sole agency authorised to use such force (Landes & Posner, 1975; Polinsky, 1980; Polinsky & Shavell, 2000). Another instance where public enforcement might be desirable is when allowing private enforcement substantially increases the risk of frivolous litigation, and the measures to curtail that risk are insufficient. This seems to be an exceptional situation because there should be other ways to address this besides prohibiting private enforcement. Also this would suggest that private enforcement does not bring forward sufficient valuable information.

[22] Moreover, since people are concerned about the speed and tenacity with which public enforcement moves, making that same enforcement the repository of all enforcement related information may raise concerns.

[23] A bounty system would not work as a substitute for private enforcement in this particular context because to match the liquidity enhancing effects of private civil litigation the bounty must go to all shareholders who suffered harm (not just the person providing information)

[24] Monetary sanctions involve the cost of transferring the money and this is usually considered fairly small (Becker, 1968; Shavell, 1985). Increasing monetary sanctions to a very high level might induce the chilling of desirable behaviour (Khanna, 1996), but we do not discuss that in much depth here; instead we focus on the importance of enforcement expenditures in increasing the likelihood of being sanctioned.

[25] It may prove useful to have criminal liability if the focus is on changing social behaviour because the criminal law would send a signal about what is considered acceptable behaviour in society (Khanna, 1996).

[26] Polinsky and Shavell (2008) among others discuss this and other related issues in detail.

[27] By analogy a similar argument can be made for public enforcement not needing as much information from private parties because public enforcers know who to watch (i.e. controllers). Although a plausible argument, the public enforcement authorities cannot monitor all firms all the time, but large minority shareholders have an incentive to monitor the controllers of those firms in which they have invested. Also such an argument does not address liquidity concerns.

[28] An alternative may be a derivative suit mechanism.

[29] The possibility of concurrent SEBI enforcement, criminal enforcement, and private enforcement could be achieved via legislative amendments to the SCRA (1956) and SEBI Act (1992).

[30] Another potential concern with arbitration is regarding where it might occur. In Delhi there are new arbitration forums that are beginning to be implemented and throughout India arbitration is gaining popularity as an alternative form of dispute resolution. Another option might be to make the situs of the arbitration the London Court of International

Arbitration (a body that Indian business is quite familiar with as it is a frequent situs for arbitration) (Khanna, 2009c). One may also consider designating a third party like a non-governmental organisation (NGO) to bring litigation on behalf of shareholders (Milhaupt, 2004). However if the recovery does not go to shareholders then we do not benefit from the liquidity enhancing effects of private enforcement. Another option may be to allow stock exchanges to monitor and enforce certain laws. This may also have some benefits (Pritchard, 2003), but again unless it provides for private recoveries it will not address the liquidity concerns. Moreover if information from victims cannot be easily obtained by the NGOs or the exchanges then again there is a need for some kind of private enforcement. In any case, exchange enforcement or NGO enforcement would have its own concerns and agency costs that might reduce their usefulness for enhancing enforcement. One advantage of both NGO and exchange enforcement is that the prospect of frivolous litigation is less than with purely private enforcement. If it were decided to design an arbitration regime it would be desirable to consider ways in which to limit the prospect of frivolous litigation.

[31] In addition it might be worth considering the provision of some measure of amnesty or sanction reductions for firms that come forward themselves about governance concerns at their firms. This would help to reduce enforcement costs for the government; also stopping governance problems early on can help to reduce the harm caused (Kaplow & Shavell, 1994). Such sanction reductions can be considered a form of reward as well.

[32] For details on delays in general see Priest (1989), and on accuracy in general see Kaplow (1994).