Where the Traditional and Modern Collide: Indian Corporate Governance Law

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I. INTRODUCTION

Less than one month after the Indian government lifted the ban on foreign investment in India's stock exchanges, the New York Stock Exchange's (NYSE) parent company, the NYSE Group, Inc., made the first move at driving the stock exchange consolidation race into Asia.[1] Consistent with the five percent cap for foreign investors in Indian bourses, the NYSE Group, Inc., joined by Goldman Sachs Group, Inc., General Atlantic LLC, and Southbank Asian Infrastructure Fund, acquired a combined twenty percent stake in India's National Stock Exchange (NSE), the nation's largest bourse.[2] One month later, Deutsche Börse purchased a five percent stake in the Bombay Stock Exchange, the

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1. Anil Varma & Edgar Ortega, *In India, NYSE Buys Slice of Market*, INT'L HERALD TRIB., Jan. 11, 2007, at 14; Aaron Lucchetti & Eric Bellman, *NYSE Extends Reach to India*, WALL ST. J., Jan. 11, 2007, at C3.

2. Varma & Ortega, *supra* note 1.

country's oldest bourse.[3] Eight years ago, on March 11, 1999, a similar landmark event occurred when software firm Infosys Technologies Ltd., listed on Nasdaq, became the first Indian company to offer its shares on an American stock exchange.[4]

Each of these strategic moves was driven by the prominent role stock exchanges play in a national economy, particularly for emerging economies and developing nations.[5] Generally, stock markets encourage investment by providing a secondary market for buyers and sellers to trade securities, thereby enabling corporations to expand their businesses.[6] As corporations' share prices rise and their financial assets increase, dividends are distributed back to the stockholders, increasing their wealth.[7] In developing nations, this shifting of capital from idle to productive activities, such as investments, allows the aggregation of scattered wealth and provides an essential means for governments, small businesses, and big corporations to raise money to expand their business activities, reduce unemployment, and promote nationwide, long-term economic growth.[8] However, a key component of a well-functioning market is effective regulation and governance.

The primary motivation of Indian firms forming alliances with Western exchanges by cross-listing on both U.S. exchanges and Indian exchanges is the desire to acquire global visibility.[9] But cross-listing may also improve corporate governance and enhance competitiveness in the global marketplace,[10] thus linking economic development and poverty reduction in developing nations to better corporate governance. While the periodic failure of corporate governance practices in Western nations like the United States and Great Britain makes headlines, the gap between governance quality in developed and developing countries is far more significant.[11] In this regard, stock exchanges have played a

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3. Heather Timmons, *Stock Exchange Ties Are Expanding, But To What End?*, INT'L HERALD TRIB., Feb. 22, 2007, http://www.iht.com/bin/print.php?id=4691603; Lucchetti & Bellman, *supra* note 1.

4. Rajesh Mahapatra, *India on Wall Street*, SPAN, May/June 2005, at 36, *available at* http://usembassy.state.gov./posts/in1/www.tsmayjune6.pdf.

5. MSN Encarta, Stock Exchange: The Importance of Stock Exchanges, http://encarta.msn.com/encyclopedia_761560145/Stock_Exchange.html#s22 (last visited Oct. 17, 2007).

6. *Id.*

7. *Id.*

8. NSE: About Nairobi Stock Exchange, What Is the Importance of This Market to the Economy?, http://www.nse.co.ke/newsite/nse_faqs.asp?cat=faqs&q=150 (last visited Oct. 17, 2007) [hereinafter Nairobi Stock Exchange].

9. Mahapatra, *supra* note 4, at 36.

10. *Id.* at 37.

11. Rajesh Chakrabarti, *Corporate Governance in India—Evolution and Challenges*, ICFAI J. OF CORP. GOVERNANCE 1, 1-2, (2005), *available at* http://ssrn.com/abstract=649857.

significant part in upholding good corporate governance, such as the NSE's key role in reforming India's securities markets and advancing key corporate governance principles, namely "transparency, efficiency and market integrity."[12]

Although regulatory technicalities, such as differing accounting practices, incompatibility with Generally Accepted Accounting Principles, and the recent Sarbanes-Oxley legislation make it difficult for Indian companies to list on American exchanges, Indian scholars suggest that adhering to these stringent regulations will result in corporate discipline that could have far greater beneficial effects in the long run.[13] While some scholars suggest that the recent acquisitions will only serve to raise the NSE's global reputation and give Western capital markets a foothold in a booming, emerging market,[14] others argue that the acquisitions may hold significant potential for implementing more stringent corporate governance and developing a more sophisticated system of corporate law.[15] In particular, Indian governance experts view the Sarbanes-Oxley Act of 2002 (SOX) as a template for their own reforms and as a means to combat the corruption and weak enforcement that has historically restricted the growth and popularity of many Indian companies and securities markets. They argue that such reform will bring corporate governance in India in line with the same rigorous governance standards foreign investors demand and regulators expect.[16]

II. HISTORY OF INDIAN CORPORATE LAW

Similar to other developing nations, India's corporate culture is faced with both traditional and corporate settings—"family-run businesses, dominant shareholder settings, corruption, and political influences exist side-by-side with companies with diversified

12. Press Release, NYSE Group, Inc., NYSE Group to Purchase 5% Equity Interest in National Stock Exchange, India's Largest Financial Marketplace (Jan. 10, 2007), http://www.nyse.com/press/1168342114215.html.

13. Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 NEW ENG. J. INT'L & COMP. L. 231, 250 (2006); Mahapatra, *supra* note 4, at 37.

14. Lucchetti & Bellman, *supra* note 1.

15. *See* Jenny Anderson & Martin Fackler, *N.Y. Stock Exchange Chief Determined To Go East*, N.Y. TIMES, Jan. 31, 2007, at 11 (stating that in a strategic alliance the NYSE Group recently set up with the Tokyo Stock Exchange, it mentioned, among other things, setting up working groups to create links in areas like corporate governance and regulation).

16. Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002); Knowledge@Wharton, *Is Indian Business Ready for a Brave New World of Tough Corporate Governance?*, Dec. 14, 2005, http://knowledge.wharton.upenn.edu/article.cfm?articleid=1332.

shareholding and good corporate governance practices."[17] This assortment of corporate features can be traced back to India's legal and political origins from the English common law. Although economically impoverished when it became an independent nation in 1947, India had the markings of a strong corporate law structure already in place.[18] Unlike other nations also emerging from colonialism, India had four fully-operational stock exchanges, each delineating its own listing rules.[19] The Indian Companies Act (ICA) was passed in 1956, along with other regulations protecting investors' rights.[20]

The country's embrace of socialism during the following decades, however, inhibited the potential growth of corporate sectors by creating a regime that promoted red tape and bureaucracy.[21] The "License Raj" system was created, requiring government permission to engage in standard business decisions, such as diversifying lines of business, changing production schedules, and even importing materials and goods needed for manufacturing and production.[22] As political connections became increasingly important to obtain these permits, nonstate enterprises subject to this licensing system faced prevalent corruption and inefficiency.[23] In addition, rising tax rates encouraged inventive accounting practices to get through the loopholes.[24]

The system "ensured that the businesses remained in the hands of the rich and the politically connected families," whose members dominated management of their companies and retained majority stakes.[25] As public and private financial institutions became the families' biggest creditors and acquired large blocks of stock in family companies, this power became further entrenched.[26] The banks acquired representation on the companies' boards of directors and rather than "keeping their clients on the right track," became rubber stampers for management in order to retain the families as clients.[27] Because most companies were held as family businesses, boards of directors derived

17. Mohanty, *supra* note 13, at 231.
18. Chakrabarti, *supra* note 11, at 9.
19. *Id.* at 14; Knowledge@Wharton, *How Some Firms in India Succeed by Bypassing Entrenched Financial and Legal Systems*, Nov. 1, 2006, http://knowledge.wharton.upenn.edu/article.cfm?articleid=1596&CFID=3677137&CFTOKEN=82911816.
20. *Id.*
21. *Id.*
22. *Id.*
23. Mohanty, *supra* note 13, at 235.
24. *Id.*; Chakrabarti, *supra* note 11, at 15.
25. Mohanty, *supra* note 13, at 235.
26. Chakrabarti, *supra* note 11, at 15.
27. *Id.*

their power from controlling shareholders, and corruption thrived in the government and legal system. It was an era that saw many legal protections on paper but only weak protections for investors in practice.[28]

A. Family-Run Businesses: Disadvantages and Advantages

The prevalence of family-run firms is a widely addressed issue in corporate governance.[29] Family-run firms have played a significant role in various economies of Europe and Asia, retaining competitive advantages and holding significant potential for abuse of minority shareholders' rights.[30] Family ownership is more prevalent in countries with weak legal protection for minority shareholders essentially because it acts as a substitute for the weak legal system.[31] In family-run businesses or firms, members of a single family control ownership of a corporation as controlling shareholders and make up a large portion of its management, enjoying private control benefits that distort decision-making to the detriment of minority shareholders.[32] The basic premise is that shareholders have few legal rights to seek payment of dividends "or even a return on their initial investments."[33] Dividends are generally paid at the discretion of the board of directors, and although those dividends "may not be withheld in bad faith," directors exercise significant liberty in allocating a corporation's financial assets, i.e., determining when funds should be reinvested in internal corporate projects rather than distributed to shareholders.[34] When majority shareholders are also managers with access to work-related compensation and other benefits, they are generally less likely to pay out dividends.[35]

Family-run businesses present opportunities for the controlling shareholders to engage in expropriation detrimental to minority shareholders.[36] Where the interests of majority and minority shareholders

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28. Knowledge@Wharton, *supra* note 19; Mohanty, *supra* note 13, at 236.

29. Hubert Shea, Family Firms: Controversies over Corporate Governance, Performance, and Management 5-6 (2006), http://ssrn.com/abstract=934025.

30. Pablo Martin de Holan & Luis Sanz, *Protected By the Family? How Closely Held Family Firms Protect Minority Shareholders?*, 59 J. BUS. RESEARCH 356, 357 (2006), *available at* http://www.sciencedirect.com.

31. De Holan & Sanz, *supra* note 30, at 356.

32. Shea, *supra* note 29, at 2; Chakrabarti, *supra* note 11, at 7.

33. Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356, 361 (2004).

34. *Id.* at 361-62.

35. *Id.* at 362.

36. Tatiana Nenova & Catherine Hickey, *Self-Dealing*, WORLD BANK PUB. POL'Y J., Sept. 2006, at 1, 2, *available at* http://rru.worldbank.org/documents/publicpolicyjournal/312Nenova_Hickey.pdf.

are not aligned, controlling shareholders are able to engage in self-dealing (the ability to extract private benefits) and insider trading (where controlling shareholders have superior access to inside information relative to dispersed outside investors and may trade on it to gain profits).[37]

The prominent corporate structure in India has long been the "pyramid" of control held by corporate families owning multiple businesses. This allows for self-dealing by expropriating shareholder value through the tunneling of corporate gains to other business entities within the group.[38] Throughout the 1990s, Indian businesses were believed to have "tunneled considerable amount[s] of funds up the ownership pyramid thereby depriving the minority shareholders of companies at lower levels of the pyramid of their rightful gains."[39] Other conflicts within family-run businesses include: excessive compensation schemes, risk avoidance, internal rivalries amongst family members (which impede good decision-making), and management positions handed down to family members with inadequate professional qualifications, all of which generally impede growth.[40]

While some studies show that family-run firms may be unable to compete with modern corporate structures' decentralized decision-making and economies of scale, in many cases family-run firms actually perform better than nonfamily firms, because they possess a flexibility that allows them to deliver higher returns on assets.[41] These theories suggest that ownership concentration and unification of ownership and management reduce agency costs.[42] For example, in nonfamily firms, managers possessing superior information have the incentive to pursue their own interests, undermining the best interest of the shareholders by way of firm value and a higher share price.[43] The reduction of agency costs is best seen in family-run firms where management needs less monitoring by shareholders because it constitutes the majority of the shareholders and has as much interest in a higher share price as minority shareholders, thereby aligning both majority and minority shareholders' interests.[44]

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37. Shea, *supra* note 29, at 3.
38. Chakrabarti, *supra* note 11, at 7, 11-12.
39. *Id.* at 12.
40. Shea, *supra* note 29, at 5.
41. *Id.* at 4.
42. *Id.* at 3.
43. *Id.* at 3-4.
44. *Id.*

Family firm owners do not see economic self-interest as their only goal.[45] They are more likely than nonfamily firms to manage their businesses and profits for the long term so that the business can be passed on from generation to generation.[46] This not only reduces agency costs, but it also creates a greater incentive for self-discipline and conscientious management of the business.[47] Family firms also create more "employment stability and loyalty" and promote a stronger sense of commitment to the business based on family reputation, all the while enhancing employee motivation and morale.[48] Managerial ownership of corporate equity correlates to an increase in the firm's value insofar as managers ensure they can keep their jobs and optimize their use of corporate funds, regardless of the effects on other shareholders.[49]

Concentrated ownership and family-owned businesses are particularly important in societies with weak legal protection for property rights because they "reduce transaction costs and asymmetric information problems," as seen in the examples of Korean and Italian corporate governance structures.[50] Family-run businesses are also prevalent where there is "[p]oor development of external financial markets."[51] Studies show that in many East Asian nations, a firm's value rises as the controlling shareholder's stake rises but "declines as the excess of the largest owner's management control over his equity stake increases."[52] While family-run businesses have advantages and disadvantages, businesses, whether family- or publicly-owned, that "protect their minority shareholders will have considerable advantages over those that do not."[53]

B. *Corporate Governance Laws Post-1991*

Liberalization of the Indian economy in 1991 ended the licensing and permit practices under the System Raj, resulting in substantial ongoing economic reform over the past fifteen years.[54] However, as a consequence of India's largely ineffective legal system and weak

45. *Id.* at 3.
46. *Id.* at 4.
47. *Id.*
48. *Id.* at 5-6.
49. Chakrabarti, *supra* note 11, at 8.
50. *Id.* at 11-12. *See generally* Amir Licht, *Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform*, 22 BERKELEY J. INT'L L. 195 (2004); Boot & Macey, *supra* note 33, at 388.
51. Chakrabarti, *supra* note 11, at 12.
52. *Id.*
53. De Holan & Sanz, *supra* note 30, at 1.
54. Mohanty, *supra* note 13, at 235-36.

protection of minority shareholders' rights, historically common issues, such as dominant shareholders, continue to compromise effective governance.[55]

Although India's British influence provides some of the best shareholder rights' protection on paper, the lack of enforcement of these laws has led to a consistent level of distrust of the country's legal system amongst entrepreneurial managers.[56] In a recent study conducted amongst Indian entrepreneurs, researchers found that legal disputes were largely settled outside the system, bypassing courts of law to rely instead on informal dispute resolutions.[57] In a survey of 213 entrepreneurs and executives of small to medium-sized firms, about 85% had the founder's family as its largest owner.[58] Of the firms having unlimited liability (over half of the 213 firms), 96% of owners would expect to protect their personal assets in case of business failure by negotiating with lenders for an extension; only 22% said that they would also file for personal bankruptcy.[59] "[I]nformal governance mechanisms based on trust, reputation and relationships" were more effective and more widely relied on than legal remedies when settling breaches of contract and other conflicts.[60]

Almost half of those surveyed said that mutual friends and business partners were the best mediators for disputes.[61] About twenty-six percent reported that nongovernmental organizations, such as trade associations, were good mediators, and only twenty percent would prefer to rely on the country's legal system.[62] Rather than rely on the legal system, firms rely on bribes and upon friends of government officials to overcome corruption.[63]

Contrary to common perception, corruption and weak regulatory protections for investors have not prevented a steady rate of growth for

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55. *Id.* at 236; Chakrabarti, *supra* note 11, at 11.

56. Chakrabarti, *supra* note 11, at 10. The major difference between developed and developing countries lies in law enforcement. As Chakrabarti states, enforcement may play a more significant role than even the quality of the law itself, such as for insider trading. As such, where there is "weak enforcement of property rights and contracts, entrepreneurs and managers find it difficult to signal their commitment to the potential investors, leading to limited external financing and ownership concentration." Consequently, mechanisms for corporate control and governance lose their effectiveness. *Id.* at 10-11.

57. Knowledge@Wharton, *supra* note 19.

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

India's small and midsized firms.[64] This suggests that not all types of corruption pose a serious impediment to a healthy business economy.[65] The common goal of high prospective profits seems to keep the interests of investors, government officials, entrepreneurs, and managers aligned.[66] Additionally, the family-run business scenario, despite its shortcomings, does have its benefits in terms of reducing agency costs and asymmetric information.[67]

India's Constitution gives the Parliament exclusive power to make laws with respect to the basic functions of a company, particularly in terms of the "incorporation, regulation, and winding up of companies."[68] The Indian Companies Act, enacted by Parliament in 1956, regulates Indian companies in general matters.[69] The Securities and Exchange Board of India Act of 1992 and the Listing Agreements provide regulations for all companies listed on India's stock exchanges, while the Institute of Chartered Accountants of India created by the Chartered Accountants Act of 1949 controls the accounting profession.[70]

In addition, much of Indian corporate governance is implemented through committees, both designated by the government and the corporate industry itself.[71] And while many of these committees have tried to make the corporate governance regulations mandatory, there has always been opposition by the corporate industry.[72] Mandatory laws would diminish corporations' ability to wield political influence on corporation legislation and policy.[73] For example, the Companies (Amendment) Bill of 2003 attempted to further amend the Indian Companies Act of 1956 by making governance regulations mandatory and incorporating some provisions based on SOX.[74] However, it was de-prioritized due to influential corporate houses and was then reverted for redrafting.[75]

Nonetheless, the initial effort in India to inspire public confidence in business through corporate governance was industry-driven.[76] In 1998,

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64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*
68. Mohanty, *supra* note 13, at 240.
69. *Id.* at 240-41.
70. *Id.* at 241.
71. *Id.* at 241-42.
72. *Id.* at 242.
73. *Id.*
74. *Id.* at 244.
75. *Id.* at 242-43, 250-51.
76. *Id.* at 241.

the Confederation of Indian Industry (CII) set up a voluntary code entitled "Desirable Corporate Governance."[77] The CII code was initiated in response to public concern for small investors' protection, as well as to promote transparency in business and further the convergence toward international standards of disclosure.[78] Between 1998 and 2000, over twenty-five leading companies voluntarily adopted the code, including both family-owned businesses and companies with diversified shareholding like Infosys Ltd., which later became the first Indian company to list on an American stock exchange.[79]

This effort came on the heels of the financial scandals of the 1990s.[80] The Indian stock market scandals of 1992 and 2001, and the "vanishing companies scam" during the capital boom of the 1990s demonstrated that corporate governance problems in India did not just occur in the traditional dominant shareholder settings but could still occur within modern corporate structures. This led to an even greater urgency for more stringent corporate governance reform.[81] The stock market scandals of 1992 and 2001 were both triggered by brokers who purchased stock at extraordinarily low prices, inflated the prices, and then sold the stock at higher prices, in turn causing Sensex, the Bombay Stock Exchange, to crash by 570 points in 1992 and 147 points in 2001.[82] These brokers made arrangements with corporate houses and financial institutions that experts say might have been avoided with stricter corporate ethical standards.[83] The "vanishing companies scam" consisted of more than four thousand companies raising over Rs. 54,000 crore from investors and then simply vanishing, i.e., failing to comply with the listing requirements of the exchange and leaving investors powerless to protect their investments.[84] This was largely attributed to the Securities and Exchange Board of India's (SEBI) ineffective supervisory powers, which were exacerbated by SEBI's inability to go after the fraudulent

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77. N. Kumar, *Foreword* to Desirable *Corporate Governance—A Code,* CONFEDERATION OF INDIAN INDUS., Apr. 1998, at iii.

78. *Id.*

79. Bernard S. Black & Vikramaditya S. Khanna, *Can Corporate Governance Reforms Increase Firms' Market Values: Evidence from India* (Univ. of Mich. Law Sch., Legal Studies Research Paper No. 07-002, 2007), *available at* http://ssrn.com/abstract=914440.

80. Mohanty, *supra* note 13, at 239.

81. *Id.* at 239-40.

82. *Id.* at 238 n.27.

83. S. Sivakumar, *Menace of 'Vanishing Cos'*, HINDU BUS. LINE—INTERNET EDITION, July 7, 2002, http://www.thehindubusinessline.com/iw/2002/07/07/stories/2002070700620700.htm.

84. *Id.*

companies, merchants, and investment bankers that took the companies public in the first place.[85]

The most significant change to corporate governance reform in the years since liberalization occurred in 1992 with the establishment of the SEBI and the development of the Desirable Corporate Governance Code in 1998.[86] Although the voluntary approach was insufficient to persuade investors to invest in Indian firms,[87] the SEBI, which was established to "regulate and monitor stock trading," and the stock exchanges themselves have performed a key role in instituting reforms and setting up the fundamental rules of corporate behavior in India.[88]

Like other attempts at regulation, the listing requirements imposed by the stock exchanges required transparency, but noncompliance was rampant and usually went unpunished.[89] Clause 49 of the Listing Agreement was one of the most important reforms in recent years and represented a turning point for Indian corporate governance.[90] The new amendments, inspired by SOX and codifying many of the provisions previously offered in the Desirable Corporate Governance Code,[91] deal with stricter board of directors independence standards and new compensation disclosure rules. Clause 49, which was gradually enacted, the final version of which was put into effect in January 2006, also marked one of the first times that the SEBI imposed strict standards on public companies listing with Indian stock exchanges to comply with mandates, under severe pecuniary penalties or threats of delistment.[92]

These reforms reflect the Indian government's desire to be seen as a leader amongst emerging economies, while attracting and retaining foreign investment and gaining access to global capital markets through cross-listings on international stock exchanges.[93] The reforms have led to significant changes, such as the formation of companies with diversified shareholding, the creation of competitive pressure with the entry of foreign companies into the Indian business sector, and the increase in research, analysis, and transparency, all due in part to the presence of a growing number of foreign institutional investors in the Indian equity

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85. *Id.*
86. Chakrabarti, *supra* note 11, at 18.
87. Black & Khanna, *supra* note 79, at 4.
88. Chakrabarti, *supra* note 11, at 18.
89. *Id.* at 17.
90. *Id.* at 19; Black & Khanna, *supra* note 79, at 4-5.
91. Michael Anuszkiewicz, *India Steps up Governance Reforms*, INSTITUTIONAL SHAREHOLDER SERV., http://www.issproxy.com/governance/publications/2005archived/191.jsp (last visited Oct. 17, 2007).
92. *Id.*; Knowledge@Wharton, *supra* note 16.
93. Knowledge@Wharton, *supra* note 16; Chakrabarti, *supra* note 11, at 2.

markets.[94] In fact, studies in India have shown that "foreign ownership helps performance only if foreigners constitute the majority shareholders."[95] While corruption and a weak dispute resolution and enforcement system may not have stopped economic growth, scholars still suggest that the development of emerging markets is held back by corruption and poor governance, which likewise diminish investor confidence.[96]

The major areas of ineffective governance include lack of disclosure to shareholders and accountability, principally stemming from a lack of enforcement.[97] Currently, listed firms have concentrated ownership and low valuations, paying lower dividends relative to firms from countries with stronger legal protections.[98] And while family-run firms have many stakeholders, the problem lies in aligning the interests of the majority shareholders with the minority shareholders.[99] One of the most important aspects of this reformation will be to continue improving the legal system, so entrepreneurs will trust it to resolve disputes and enforce contracts. Significant reformation and buildup of the legal system could then promote "the development of stock markets" and attract "more foreign capital inflows" to India's emerging economy.[100]

III. The Clash Between Adopting Western Ideas and Resolving Cultural Differences

India's corporate culture reflects the great divide between corporate governance standards in developed countries and those in developing countries.[101] To minimize this gap, many "Indian scholars, accountants, and lawyers" feel that India should implement legislation similar to that of the United States' SOX, with particular emphasis on investor protection with regard to audited financial statements and disclosure, independent audit committees, and penal provisions for white-collar crimes.[102] The predominance of Anglo-American reforms in this area stems from the dominance of American and British institutional investors in the global securities marketplace and the United States' prominence in international organizations, such as the International Monetary Fund and

94. Anuszkiewicz, *supra* note 91.
95. Chakrabarti, *supra* note 11, at 13.
96. *Id.* at 10-11.
97. *Id.*
98. *Id.* at 2.
99. *Id.*; Knowledge@Wharton, *supra* note 16.
100. Knowledge@Wharton, *supra* note 19.
101. Chakrabarti, *supra* note 11, at 1-2.
102. Mohanty, *supra* note 13, at 232.

the World Bank.[103] These organizations lend money to developing nations on the condition that they implement certain governance mechanisms, the basic framework of which can be found in the Organization for Economic Co-operation and Development Principles of Corporate Governance (OECD Principles).[104] India observes the major OECD Principles, which provide guidance for stock exchanges and corporations, particularly publicly traded companies, to develop "best practice" standards for corporate governance, based on the roles and interactions of stakeholders rather than strict and inflexible guidelines.[105] In the end, India and its corporate industry should not just adopt U.S.-style legislation, but should also identify their own system of corporate governance, by taking into account India's history of traditional and modern corporate structures while still promoting the benefits of diversified shareholding, better transparency, and the presence of foreign investors.[106] Only then will the corporate governance system be effective.

One such example of "best practices" is that of Italy, which, according to some scholars, appears to have a "completely dysfunctional corporate governance system" but has a GDP per capita rivaling that of Great Britain, one of the most effective corporate governance systems in the world.[107] Unlike the United States, Italy has a largely insufficient legal system, characterized by its complete inability to protect noncontrolling shareholders. The market-based control systems that characterize U.S. corporate governance are replaced by political involvement and internal financing by small firms.[108] Like India, Italy is "characterized by complicated cross and pyramidal ownership structures," which disadvantages minority shareholders, entrenches management, and "prevents capital market discipline."[109] But the Italian economy has not suffered because of these failings, primarily because the country has a disproportionately large number of small firms (firms with anywhere from 20 to 200 employees) and is thereby able to avoid agency problems because there is no separation of ownership and management.[110] These small firms do not require complex solutions to corporate governance problems because they are "financed and managed

103. Licht, *supra* note 50, at 232.

104. *Id.* at 210.

105. Chakrabarti, *supra* note 11, at 13; ORG. FOR ECON. CO-OPERATION & DEV., OECD PRINCIPLES OF CORPORATE GOVERNANCE 11 (1998) [hereinafter OECD PRINCIPLES].

106. Knowledge@Wharton, *supra* note 16.

107. Boot & Macey, *supra* note 33, at 365.

108. *Id.* at 386.

109. *Id.*

110. *Id.*

by individual entrepreneurs and their families."[111] As a result of family ownership, these firms employ other family members and friends who are committed to the business for the long run and, therefore, have stronger incentives to monitor the firm more diligently.[112] Despite the system's shortcomings, investors and entrepreneurs in Italy innovate around the system's deficiencies.[113]

By contrast, the U.S. system relies heavily on the disciplinary capital markets, pressuring managers to deliver profits; when managers' interests are not aligned with those of shareholders and do not maximize their benefits, shareholders may simply sell their stock in the company.[114] This will cause share prices to decline and lead to the replacement of management or to a takeover which would, in turn, result in management being replaced.[115] This objective and flexible style has its benefits, but it also results in both employees and high-level managers making short-term, rather than long-term, commitments to firms.[116] This reduces the incentives of both managers and firms to make firm-specific investments, such as in employment relationships.[117] Likewise, U.S. investors usually engage in transactions at arm's length rather than as relationship investors.[118] As a result, U.S. investors generally are not given the same privileged, detailed information about firms from which institutional investors in other countries may benefit.[119]

A. *Sarbanes-Oxley's Lessons for India?*

While in most developed countries, such as the United States, managerial agency costs form the bulk of the corporate governance issues, in developing countries, where ownership is traditionally highly concentrated, other causes of ineffectual corporate governance are prevalent.[120] In this regard, the conglomeration of traditional and modern corporate structures becomes evident. In India, the board of directors and management are usually dominant shareholders themselves or are closely linked to the firms they oversee as a result of their close

111. *Id.* at 387.
112. *Id.* at 387-88.
113. *Id.* at 387.
114. *Id.* at 388.
115. *Id.* at 381.
116. *Id.* at 386-87.
117. *Id.* at 384.
118. *Id.* at 383.
119. *Id.* at 383-84.
120. Mohanty, *supra* note 13, at 234.

relationships with the majority shareholders.[121] Therefore, Indian corporate governance relies on two primary requirements to overcome the banes of traditional family-held businesses: "[t]ransparency in decision-making" and accountability in protecting the interests of all the stakeholders of a firm, including those of the minority investors.[122] However, as modern corporate structures, such as diversified shareholding, emerge, so do managerial agency costs. As such, corporate governance must also provide rules regulating disclosure and accounting principles that meet the standards of countries with more developed and sophisticated financial markets.[123] One study suggests that major issues plaguing India in the realm of corporate governance are: (1) "the subordination of the boards to the management," (2) "lack of transparency and disclosure," (3) "self-dealing," and (4) "manipulation of finances and accounts."[124] To address these, India should take from SOX its provisions requiring independence of audit committees, accountants, and officers, those imposing corporate accountability on officers and directors of companies, and its stringent penalty provisions.[125]

The first issue is the separation of power between various law-making bodies, as opposed to the concentration of such power in one governing body as seen in SOX. The primary regulations for accountants in India are provided by the Institute of Chartered Accountants of India (the Institute), the Indian Companies Act (ICA), and the SEBI Act of 1992.[126] Section 210A of the ICA created the National Advisory Committee on Accounting Standards, which advises the government on the adoption of new accounting policies and standards.[127] Accountants are registered and certified each year by the Institute, which also "sets up ethical, accounting, and professional standards" for them to follow, including continuing education and peer review.[128] Also, chartered accountants accused of wrongdoing are investigated and must submit to disciplinary proceedings held by a body of judicial authority within the Institute. This lack of consolidated control, where multiple authorities have the power to regulate different aspects of the profession, leads instead to corruption.[129] Also, many issues arise because of unsettled

121. *Id.*
122. *Id.*
123. *Id.* at 237.
124. *Id.* at 234.
125. *Id.* at 246-47, 252.
126. *Id.* at 252.
127. *Id.* at 247, 252; Companies Act, No. 1, § 210A (1956) (India) [hereinafter ICA].
128. Mohanty, *supra* note 13, at 252.
129. *Id.* at 253-54.

questions about the SEBI's authority.[130] By contrast, the U.S. government's response in SOX was to set up the Public Company Accounting Oversight Board (PCAOB).[131] It is suggested that leaving such authority in one supervisory body, such as a PCAOB, may make for a more efficient regulatory regime.[132]

Financial or audit statements are a public corporation's principal disclosure obligation to its shareholders. These accounting disclosures are an important corporate governance tool that assists companies in meeting their fiduciary duties to shareholders by ensuring that investors and the public base investment decisions on accurate audit statements.[133] For successful securities markets to develop, regulations must ensure the independence and integrity of audit committees by enabling accountants to expose undisclosed self-dealing transactions and insisting on proper disclosure.[134]

ICA section 292A, for example, requires all public companies with approximately $1.01 million in capital to form audit committees, two-thirds of which "will be directors other than the Managing Director or full time directors."[135] But this provision does not include a requirement for audit committee members, and a lack of independent directors will likely lead to conflicts of interest.[136] Also, under the ICA, the board of directors can disregard the recommendations of the committee by giving its reasons in writing, so the directors have the ultimate power regarding financial management and the committee.[137] Where directors in family-held businesses in India receive little or no direct monetary compensation, the result is usually the creation of nonindependent directors or even a simple extension of the existing board of directors instead of an independent committee free from vested interests.[138]

On the other hand, SOX requires the formation of an independent audit committee, where at least one member is a financial expert, to establish the credibility of the reporting system.[139] SOX provisions include: the creation of a fully independent committee, better training for audit committees, stringent liability provisions to deter audit

130. Chakrabarti, *supra* note 11, at 13-14.
131. Sarbanes-Oxley Act, *supra* note 16, § 101.
132. Mohanty, *supra* note 13, at 253-54; Sarbanes-Oxley Act, *supra* note 16, § 101.
133. Licht, *supra* note 50, at 225-26.
134. *Id.* at 226.
135. Mohanty, *supra* note 13, at 257; ICA, *supra* note 127, § 292A.
136. Mohanty, *supra* note 13, at 257-58.
137. *Id.* at 257.
138. *Id.* at 253-54.
139. *Id.* at 257.

committees from ignoring known fraudulent activities, and better remuneration for independent directors, all of which would likely lead to an improvement in this area.[140] However, Section 292A of the ICA has recently been updated for listing companies, with Clause 49 requiring that all members of a company's audit committee be nonexecutive directors, with a majority being independent directors, one of whom must be knowledgeable in finance and accounting. This committee has the authority to govern any matter specified in section 292A and to perform whatever internal due diligence is necessary, as well as to seek professional advice externally.[141]

Regulations should also ensure corporate accountability to promote auditor independence and specify penalties that would actually deter fraudulent conduct.[142] ICA section 227 requires that auditors certify the companies' internal controls in their reports, disclose the loans and advances given to and made by the company, and determine whether these were prejudicial to the interests of the company.[143] Sections 232 and 233 outline the penalties for a "company's failure to comply with these provisions," while "[s]ection 233 outlines penalties for [an] auditor's non-compliance."[144] However, the penalties are so trivial that they provide little deterrence.[145] While the PCAOB can suspend a member or impose a $15,000,000 penalty, the disciplinary committee under the Indian Chartered Accountants Act can reprimand or deregister a member for a maximum of five years.[146] Increasing the penalty would "likely reduce unethical practices among Indian accountants and auditors."[147]

Like SOX, the Institute bans its accountants from taking on additional nonaudit services such as brokering, design of information systems, or investment banking services for clients in order to ensure independence and prevent the auditing firm's financial dependence on the client company.[148] But where compensation otherwise is largely inadequate, these nonaudit services bolster Indian auditors' earnings, and they end up being financially intertwined.[149] The Institute has thus

140. *Id.* at 258-59.
141. *Id.* at 257.
142. *Id.* at 257-58.
143. *Id.* at 258.
144. *Id.* at 254; ICA, *supra* note 127, § 227.
145. Mohanty, *supra* note 13, at 255; ICA, *supra* note 127, §§ 232-233.
146. Mohanty, *supra* note 13, at 255.
147. *Id.*
148. *Id.*
149. *Id.*

advised that fees received from one client should not exceed forty percent of an auditing firm's total fee income and imposed a cap on fees from nonaudit services.[150] Also, the amendments to the ICA provide that "auditors should not have any stake or voting rights in the securities of the client company."[151] In response to calls for ensuring the independence of Indian auditors, recommendations include SOX-type provisions, such as increased remuneration for auditors, prohibition of nonaudit services for auditors, and more stringent penalty provisions.[152]

The essential issue within corporate accountability, however, is the application of penalties stringent enough to encourage people to actually comply with corporate governance regulations.[153] SOX is largely known for its rigorous penalties and corporate accountability provisions.[154] While India has adopted corporate governance, accounting, and disclosure standards, the slight penal provisions have not prevented "officers, directors, and accountants from engaging in fraudulent activities."[155] Also, corporate entities have a strong influence over the SEBI and other regulatory bodies, and many penalty statutes allow for easy escape routes.[156] For example, ICA section 210 only imposes a minimal monetary penalty and six months' imprisonment for willful defaults or offenses committed by directors, whether they were negligent or failed to meet their duty of care.[157] But "liability can be waived if a competent, reliable person is appointed to ensure compliance," thus allowing the director to avoid liability altogether.[158] Other regulations such as section 217 and section 628 of the ICA, and even Clause 49 of the Listing Agreement are similar in nature and ineffectiveness.[159] What SOX does that Indian penalty statutes do not is address corporate accountability and criminal fraud in detail, particularly white-collar crime and corporate responsibility.[160] Additionally, stringent penalty provisions are needed to compel managers to practice better corporate governance through fear of punishment.[161] As such, many suggest that

150. *Id.* at 256.
151. *Id.*
152. *Id.*
153. *Id.* at 258.
154. *Id.*
155. *Id.* at 258-59.
156. *Id.* at 259.
157. *Id.*; ICA, *supra* note 127, § 210.
158. Mohanty, *supra* note 13, at 259.
159. *Id.*
160. *Id.* at 260.
161. *Id.* at 259-60.

India should adopt SOX-type enforcement provisions, while others suggest that India needs to find its own best practices.[162]

B. The Korean Example

South Korea adopted Western corporate governance elements, both successfully and unsuccessfully, after the 1997 Asian financial crisis to bring about legal and institutional reform.[163] The idea was to enhance South Korean corporate governance features with North American-inspired elements through either the cross-listing of South Korean corporations on foreign markets or through direct reform.[164]

South Korea's economy is similar to India's and faces many of the same corporate governance problems because it has been centered upon family-owned enterprises known as chaebols.[165] Chaebols are groups of "specialized companies with interrelated management servicing one another."[166] Chaebols are controlled and managed by a founding family; however, this control is not a consequence of holding a majority share block.[167] Instead they are "intricate networks of cross-holdings among numerous companies such that family members enjoy effective control without owning even half of the cash flow rights," basically rendering it impossible for outsiders to challenge the management and control of the founding family.[168]

So unlike the Indian system, this leads to agency problems. The top positions in the chaebol all rest with the direct and extended family members, consistent with their strong family- and paternal hierarchy-oriented Confucian heritage.[169] Nonetheless, while this familial management system may be valued from a cultural perspective, it has led to the exploitation of minority shareholders by the chaebols' controlling families.[170]

From the 1960s to the 1990s, South Korea grew to have one of the world's leading economies through the liberalization of its capital markets.[171] However, its corporate governance mechanisms were cited by the International Monetary Fund as a major cause of the 1997 financial

162. *Id.* at 233.
163. Licht, *supra* note 50, at 199.
164. *Id.*
165. *Id.* at 209-10.
166. *Id.*
167. *Id.* at 211.
168. *Id.*
169. *Id.* at 211-12.
170. *Id.* at 211-13.
171. *Id.* at 210.

crisis.[172] This development led South Korea to amend its corporate governance laws in 1998 and 2000, borrowing from American law and practices and using the OECD Principles as a guideline to enhance its system of transparency and efficiency in management and governance. This aim was further achieved by adopting global standards for disclosure, accounting and finance practices.[173] Despite strong objections from chaebol-controlling families to these reforms, particularly provisions establishing the right to shareholder class actions and imposing liability on managers for breach of fiduciary duty, South Korean courts have been laying the foundations for establishing these actions of corporate accountability.[174]

One of the major problems is that while reforms were implemented according to the letter of the law, they have not been followed in spirit.[175] For example, when following new requirements to establish audit committees with nonexecutive directors, some corporations staffed the audit committees with friends of the controlling families.[176] Likewise, when a "brother" company is in distress, even the government seems to overlook the fundamental principles of corporate governance and encourage the founding families to "revert to their old ways by urging profitable companies to rescue their 'brother' companies."[177]

However, with regard to cross-listing and stock exchange listing requirements, the Korean government seems eager for reform.[178] By permitting domestic firms to cross-list with foreign exchanges, South Korea wanted to enhance "the transparency and efficiency in management and corporate governance by means of globalization of the disclosure system, accounting system and practice in the securities industry."[179] The Korean government set out rules standardizing the information provided by dual-listed issuers to the domestic Korean market with the information provided for foreign exchanges.[180]

A distinction can be seen between American-inspired corporate governance elements transplanted directly into Korean law and Korean American Depository Receipts, by which companies have to comply

172. *Id.* at 212.
173. *Id.*
174. *Id.*
175. *Id.* at 213.
176. *Id.*
177. *Id.* at 213-14.
178. *Id.* at 214.
179. *Id.*
180. *Id.* (citing Hwa-Jin Kim, *Improving Corporate Governance and Capital Markets Through Cross-Listing on Foreign Exchanges*, 44 KOREA SEC. DEPOSITORY Q.J. 3 (2003)).

with an additional layer of U.S. disclosure rules and accounting standards. "Corporate governance systems utilize both legal measures and shareholding structures to mitigate [the informational] asymmetries" between investors and the corporation's agents and diminish the adverse effects.[181] "When investors and corporate agents come from different cultures, the cultural distance between them may exacerbate informational asymmetries and erode the effectiveness of governance mechanisms."[182]

The basic concepts of corporate governance and the effects of these—including accountability and self-dealing—mean different things to Americans and Koreans.[183] One distinct cultural difference to consider is the "independent" aspect of the independent director. An independent director is one who is, in Western culture, ideally unrelated to the company with regard to family or business ties, who will insist on transparency and accountability from the senior managers, and who will speak his or her mind against other board members.[184] Studies show that while American culture prefers uniqueness and speaking one's mind, the Korean culture prefers conformity.[185] Also, where Korean culture traces family roots back for generations and through multiple branches of the extended family, an unrelated and independent individual has a different meaning from the American view.[186] Moreover, while the U.S. system utilizes truly independent directors, an independent director in South Korea may be more of an outsider to the company, and, therefore, difficult to integrate with the rest of the directors and the company.[187]

The effect of national cultures also imposes large transaction costs on cross-listing issuers investing in domestic and foreign markets because of the diverse set of accounting systems across different countries and markets.[188] This results in the need to prepare multiple financial statements to meet each market's accounting system.[189] However, as there is now greater harmonization of accounting standards, cultural differences that were prominent in the 1990s have slowly diminished, especially with the International Accounting Standards

181. *Id.* at 223.
182. *Id.*
183. *Id.*
184. *Id.*
185. *Id.* at 224.
186. *Id.*
187. *Id.*
188. *Id.* at 227.
189. *Id.*

passed by the International Accounting Standards Committee.[190] The accountants in charge of "guaranteeing the quality of disclosure are affected by their cultural values."[191] It is plausible that "the disclosures of issuers who use purely local accounting professionals or are located in non-Western countries will exhibit even stronger cultural biases."[192]

In South Korea's case, it would seem that external shocks like the 1997 financial crisis would induce change even in a culture highly resistant to change, but the financial crisis has had little impact on the actual practice of accounting and corporate governance practices.[193] South Korea's accounting system is one that still prefers secrecy and family-dominated chaebols, consistent with their Confucian culture.[194] Also, "efforts to upgrade Korean issuer's corporate governance by adding an external layer of *foreign* rules and regulations through cross-listing—beneficial as they might be—are likely to meet even greater hurdles."[195] "The simple fact that laws work well in certain countries does not ensure that they will work well, if at all, in other countries."[196] In fact, "[t]he high diversity of corporate governance regimes around the world . . . suggests that some host-market systems would work better than others."[197] Cross-listing provides the opportunity to investigate the fit among legal transplants across various legal regimes.[198]

IV. STOCK EXCHANGES AND INTERNATIONAL CORPORATE GOVERNANCE CONVERGENCE

The question remains: can stock exchanges promote and improve corporate governance mechanisms? Stock exchanges have functioned as regulators since the nineteenth century, requiring their members to follow a set of rules regulating their conduct on the exchange. This includes everything from selling practices, financial responsibilities, disclosure, and even activities that do not directly relate to transactions on the stock exchange itself, such as voting rights and capital structure.[199] However, in most societies this self-regulation is accompanied by government

190. *Id.* at 228.
191. *Id.* at 229.
192. *Id.*
193. *Id.*
194. *Id.*
195. *Id.* at 231 (emphasis in original).
196. *Id.* at 207.
197. *Id.*
198. *Id.*
199. Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation*, 22 U. PA. J. INT'L ECON. L. 497, 517 (2001).

supervision,[200] presumably because of the importance a nation's stock exchanges have on its financial reputation and economy.[201] "[S]tock prices *reflect* economic conditions, and they also *affect* them."[202]

The increasing importance of stock markets and the regulations they impose for membership, however, come from the general desire by even medium and small companies to join the global securities marketplace, and the recent wave of stock exchange consolidations seems to suggest a convergence of not only stock exchanges but also corporate governance regimes. Stock markets are consistently taking a larger role in influencing corporate governance reform, although their influence is most strongly felt in the leading companies of the country.[203] For example, in India, the NSE, the country's largest exchange, ranked third in the world for number of trades in equities markets, has played a key role in reforming India's securities markets and advancing the key corporate governance principles of "transparency, efficiency, and market integrity."[204]

Although demutualization has spurred the recent wave of stock exchange consolidations by allowing them to go public and thus be bought or sold by anyone who can put together enough cash to make an attractive takeover bid, some suggest that there were actually too many stock exchanges to being with.[205] Bigger markets are arguably better because they provide a forum for trading securities, which gives buyers and sellers the most choices and opportunities to acquire stock at a price they like. Therefore, trading should flow to the most liquid and efficient market that offers the best prices and services.[206] While this might suggest that there should be one exchange trading twenty-four hours a day, regulation is the primary reason market consolidation has historically stopped at a nation's borders.[207]

In recent years, there has been a greater need for stock exchanges to engage in alliances and mergers to gain a competitive advantage. For example, post-SOX, the two main U.S. stock exchanges, the NYSE and Nasdaq, have been increasingly interested in teaming up with foreign

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200. *Id.*
201. Nairobi Stock Exchange, *supra* note 8.
202. Poser, *supra* note 200, at 513.
203. Chakrabarti, *supra* note 11, at 23.
204. Press Release, *supra* note 12.
205. Mitchell Martin, *Consolidation of Exchanges Is Slowed by Local Rules*, INT'L HERALD TRIB., Sept. 25, 1999, at 21.
206. *Id.*
207. *Id.*; Knowledge@Wharton, *LSE, NYSE, OMX, Nasdaq, Euronext . . . Why Stock Exchanges Are Scrambling To Consolidate*, Mar. 22, 2006, http://knowledge.wharton.upenn.edu.

exchanges, as they have had a difficult time competing with foreign exchanges for new corporate listings because regulations are less stringent outside the United States.[208] By acquiring a foreign exchange, a U.S. exchange could service listing companies that want to avoid SOX requirements.[209] Also, when the stock exchange consolidation movement first started in 2000, exchanges were seeking to add capabilities they did not already have.[210] Centralizing exchanges achieved economies of scale, reducing the costs of trading.[211] It also increased trading volume by attracting more traders and companies and gave buyers and sellers a central location to find each other.[212] This, in turn, improved liquidity, which helped "share prices respond more quickly and accurately to changes in supply and demand."[213] Although these alliances raised a plethora of regulatory issues, in addition to the financial and technical issues, consolidations were particularly popular amongst Western European nations after adopting the Euro as their common currency.[214] In some sense, regulatory structures have become uniform amongst these nations because of it.[215]

Some also point out the negative aspects of stock exchange mergers. There would continue to be two largely separate entities, one in the United States and one overseas, so the opportunities for cutting costs, usually the main goal of consolidation, would be minimal.[216] And while many complain about the stringent regulations, U.S. securities markets are amongst the most successful in the world, and many see the regulation as a benefit, providing a level of safety and disclosure not available elsewhere.[217] Finally, traders can now buy and sell on foreign exchanges by dealing with institutional investors and brokerages, most of whom have access to foreign local markets and operate on exchanges worldwide, thus creating a big, international exchange may not be necessary.[218]

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208. Knowledge@Wharton, *supra* note 207.
209. *Id.*
210. Knowledge@Wharton, *Stock Exchanges in the Market for Partners*, June 7, 2000, http://knowledge.wharton.upenn.edu/article.cfm?articleid=196&CFID=3677137&CFTOKEN=82911816.
211. *Id.*
212. Knowledge@Wharton, *supra* note 207.
213. *Id.*
214. *Id.*
215. Knowledge@Wharton, *supra* note 210.
216. Knowledge@Wharton, *supra* note 207.
217. *Id.*
218. *Id.*

However, despite facilitating cross-listing and gaining international listings, one of the biggest problems with such consolidations or alliances is the distinction between accounting and financial reporting standards and other regulatory measures.[219] Different regulatory regimes and differences in the behavior of market participants constitute a serious impediment when highly regulated markets such as the NYSE seek a merger partner that is equally regulated.[220] "What constitutes insider trading in the U.S. is very different from what constitutes insider trading in Hong Kong. . . . Not all companies elsewhere want to disclose what they pay their chairmen."[221] However, since NYSE listing requirements apply to all companies that list on it, regardless of whether they are domestic or foreign, many non-U.S. companies already adhere to stringent financial reporting and therefore lend to the convergence of corporate governance standards.[222]

But are these more stringent corporate governance standards useful enough for developing nations to actually attempt to adopt them? Evidence suggests that, on average, SOX had positive effects for cross-listed firms located in poorly governed countries.[223] High quality firms from countries with poor corporate governance reflect their quality and commitment to corporate responsibility by cross-listing with an exchange or in a nation that has stricter financial reporting laws and listing standards.[224] In this way, controlling shareholders give up their opportunities for self-dealing and expropriation of minority shareholders in exchange for reducing a firm's costs of capital.[225] However, firms that were well-governed, practiced a high level of disclosure in the first place, and were located in a country with high levels of disclosure suffered larger losses.[226] Because the relative benefits and costs of SOX depend on companies' pre-SOX governance standards, this proposition can be used to argue that SOX provisions would have a positive effect in India, particularly for small and medium-sized companies, although they have been very costly in the United States.[227]

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219. Knowledge@Wharton, *supra* note 210.
220. *Id.*
221. *Id.* (quoting Professor Eric K. Clemons).
222. *Id.*
223. *Id.*
224. Kate Litvak, *Sarbanes-Oxley and the Cross-Listing Premium*, 105 MICH. L. REV. 1857, 1860 (2007).
225. *Id.*
226. *Id.* at 1861-62.
227. *Id.* at 1864, 1898.

The impact of corporate governance reform can also be seen in the firms' market values.[228] The positive reaction to Clause 49 presents a stark contrast to the negative reaction to the 2002 adoption of SOX. Specifically, when the SEBI announced the plans to adopt what became Clause 49, the share prices of large firms to which the reforms applied rose by approximately four percent, relative to those firms to which these reforms did not apply.[229] Over the course of the next few days, this discrepancy in price rose to seven percent.[230] Therefore, the study showed evidence that Clause 49 reforms did increase market values of the Indian firms to which it applied, despite the fact that many of the Clause 49 provisions are similar to those of SOX.[231]

So although major Indian firms were most likely to oppose governance reform, in India the reform effort was initiated by the CII, an organization of large Indian public firms.[232] "If investors expect adoption of Clause 49 to improve governance and . . . profitability, increase access to capital, or reduce risk[,] . . . the announcement of proposed reforms, which led to Clause 49, should increase share prices."[233] Public opinion suggested that investors perceived adoption of Clause 49 and its corresponding reforms as generally beneficial for India.[234] One explanation for the differing reactions with regard to Clause 49 versus SOX is that "the same reforms could have net benefits in a poor governance country, such as India prior to Clause 49, yet net costs for already well-governed companies. Just as governance is probably not one-size-fits-all at the company level, so too, governance rules are likely not one-size-fits-all at the country level."[235]

In order to develop a well-functioning securities market, the appropriate legal, regulatory, and cultural elements must be in place, mostly to prevent self-dealing and insider trading. And while the theory states that "[c]ross-listing on a well-regulated market would serve as a

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228. As stated in the study, the difficulty with measuring the effects of corporate governance reforms on a firm's value is that reforms apply to all public companies in the country that adopts them. Thus, it is difficult to tell whether the price changes in shares arise from the reforms or from other new information. In the case of Clause 49 in India, there was a several year lag in the implementation of these reforms based on firm size. The reforms applied to larger firms first, so this is the testing group for the study. Small firms, to which the reforms applied last, are the control group. Black & Khanna, *supra* note 79, at 1.

229. *Id.*

230. *Id.*

231. *Id.*

232. *Id.* at 6.

233. *Id.* at 9.

234. *Id.* at 10.

235. *Id.* at 18.

short-cut for issuers interested in self-improving their corporate governance beyond" their home country's requirements, the "piggybacking strategy relies on an implicit assumption that the destination-market's regime would mesh smoothly with the issuer's existing regime."[236] Differences among nations, including cultural distinctions, may fail to allow plug-ins of a foreign issuer's governance system.[237] But for the most part foreign legal elements can be adopted, as studies suggest, by another legal system with some changes and adaptations.[238] "The architects of corporate governance reform may want to consider the idea of culturally compatible governance."[239] For example, South Korea has done well with its version of imported legal elements and local practices, although it must improve to a certain extent to continue competing in the global marketplace and meet international standards, an improvement that is hindered by cultural tendencies.[240]

The theory suggests that stock markets are bound to consolidate, but it is doubtful that market fragmentation will ever disappear.[241] Fragmentation, by way of differing regulations per country, helps the market function by catering to members' cultural and regulatory needs and abilities.[242] Some suggest that market dynamics show that there is a race for the top in cracking down on certain corporate governance issues, like insider trading.[243] But there are many instances in which family-run firms and dominant shareholder settings are necessary and may actually work well, such as cases like Italy, where the system just innovates around the potential conflicts. However, most scholars suggest that the backbone of this dominant shareholder setting is to have a strong legal framework so as to reinforce the family-run system or even replace it, should the family dynamics fall apart.[244]

In the case of India, it seems that some SOX-like, stringent provisions have already been adopted and will continue to be adopted as the market and corporate industry see fit, as long as they continue to correlate with positive firm values.[245] Like the case of South Korea, it is doubtful that family-run firms and dominant shareholder settings will

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236. Licht, *supra* note 50, at 231.
237. *Id.*
238. *Id.*
239. *Id.* at 232.
240. *Id.*
241. *Id.* at 236.
242. *Id.*
243. *Id.* at 237.
244. De Holan & Sanz, *supra* note 30, at 358-59.
245. *See* Black & Khanna, *supra* note 79, at 1.

ever be eliminated, as the country's history is founded on those types of corporate structures.[246] But as in Italy, it is plausible that the system will innovate around it[247] and thus enact legislation that will allow modern diversified shareholding firms to prosper and encourage them to cross-list with foreign, more stringent exchanges, while providing enough incentive for family-run dominant shareholder firms to minimize expropriation of minority shareholders.

246. *See* Licht, *supra* note 50, at 210.
247. Boot & Macey, *supra* note 33, at 388.