THE ROLE OF ENFORCEMENT MECHANISMS
FOR CORPORATE GOVERNANCE IN INDIA

MASTER THESIS
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"I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I acknowledge the supervision and guidance I have received from professor Subrata Sarkar. This thesis is not used as part of any other examination and has not yet been published."

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The Economic Times, Mumbai, 2 August 2012

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The Economic Times, Mumbai, 3 August 2012

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The Economic Times, Mumbai, 4 August 2012

INTRODUCTION

One only has to open a newspaper to know how pressing the topic of corporate governance regulation (CGR) is in India. Despite regulatory efforts to establish a minimum corporate standard in the corporate sector, India has experienced a number of frauds, insider trading cases and other scams during the last decade.¹ Not surprisingly, the securities regulator (Sebi) has extended both in staff and powers.²

The importance of good corporate governance and therefore of CGR for the economy has been covered extensively in the literature. Good corporate governance enhances companies’ access to capital markets, their profitability and ultimately market wide financial and economic growth, by reducing risk, improving management and promoting transparency and accountability.³

For developing countries a large part of the literature focuses on the lack of effective enforcement of CGR. India for instance has one of the best CGRs on paper but poor implementation severely limits its effectiveness, while CGR is particularly important in India

¹ Gupta and Verma, p. 15.
given the underdeveloped equity market, the dominance of family owned businesses and the high level of corruption.  

Within the research field of enforcement for CGR many scholars discuss the general enforcement environment, with criteria such as the independence of courts, access to courts and the length of procedures. They suggest numerous alternative enforcement mechanisms that could circumvent the problems with the general institutional environment. Notwithstanding the great importance of these aspects, sanctions are an aspect of enforcement that has so far not received much attention in the corporate governance literature. This is surprising given the relative ease with which sanctions can be reformed, compared to, for instance, the independence of courts, while their deterring effect can be substantial. This has been demonstrated for related fields such as corporate crime using the economic theory of punishment and deterrence. The potential relevance of this theory for CGR enforcement, particularly given its link with certain corporate crimes, calls for a joint treatment of both fields of study.

This thesis aims at providing such a joint treatment of CGR enforcement literature and economic theory of punishment and deterrence, in order to answer the following question: What role do sanctions play in choosing the optimal enforcement mechanism for CGR in India?

The question will be addressed according to the following structure. The thesis starts out with a discussion of the literature on corporate governance in Chapter 1, with reference to the situation in India. In Chapter 2 the regulatory structure of corporate governance in India is laid out. Chapter 3 covers the literature on the economic theory of punishment, followed by a formal model comparing various enforcement mechanisms in Chapter 4. Chapter 5 evaluates the effectiveness of the main regulators of corporate governance in India according to the deterrence model, and using data on sanctions, efficiency and effectiveness. Lastly, conclusions and suggestions for policy and further research will be provided.

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4 Chakrabarti 2007, p. 3.
CHAPTER 1 LITERATURE ON CORPORATE GOVERNANCE

In this section an overview will be provided of the existing literature on corporate governance. First, the general problems that corporate governance attempts to mitigate will be laid out, followed by the specific problems in developing countries, with special attention for India. Then an overview of the debate on the role and interaction of private and public enforcement as well as a list of specific enforcement mechanisms will be provided.

1.1 The Importance of Corporate Governance

Corporate governance can be defined as “rule of law, transparency, accountability and protection of public interest in the management of a company’s affairs in the prevailing global, competitive and digital environment”. The appointment of a management by the owners to run the business leads to a separation of ownership and control and consequently to a principal-agent problem. In order to make sure that the managers act in the interests of the shareholders, rather than in their own, the so called ‘residual powers’ resting with them must be limited. This is what corporate governance aims to do, both by imposing fiduciary duty principles on the managers and by providing the shareholders with voting rights on decisions that may affect them.

Attention for corporate governance has sparked since corporate scandals such as Enron, WorldCom and Parmalat came to light. This raised alarms for effective regulation of corporations, which’ relevance became even more clear during the financial and economic crises observed all over the world during the last decade.

The importance of corporate governance lies in its intrinsic linkage with financial and economic development, which works through several causal channels. Firstly, investors will only be willing to invest when they can be confident that a company will be managed in their interests. Effective corporate governance, by assuring this, enhances access to external financing for companies, thereby expanding companies’ investment and growth opportunities. Secondly, by

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6 Cooper 2007, p. 1.
reducing the risk of investment, corporate governance lowers the cost of capital and thereby increases company valuation, economic growth and international competitiveness. In addition, return to capital rises because with effective corporate governance, management is pressured to allocate resources to their most productive use. By requiring transparency in corporate transactions, corporate governance furthermore limits the possibilities for corrupt behaviour, which can eventually help to prevent the emergence of systemic banking crises. Lastly, good corporate governance removes distrust between stakeholders which reduces legal costs.

The link between effective corporate governance and economic growth is supported by empirical studies, provided by among others La Porta et al. and Bhattacharya and Daouk. According to La Porta et al. concentration of ownership is a symptom of weak investor protection. They argue that if the legal framework does not offer external investors sufficient protection, entrepreneurs are forced to maintain large shareholdings to align their incentives with other shareholders. The problems this brings along vary from entrenchment of the managers and consequent sub-optimal use of free cash flows to expropriation of minority shareholders and higher liquidity costs. In addition, concentrated ownership structures undermine the effectiveness of other corporate governance methods such as the market for corporate control, the market for managers, board activism and executive compensation schemes. In accordance with their hypothesis that such problems harm economic growth, La Porta et al. (2000) found a significant negative correlation between concentrated ownership and economic growth.

1.2 Challenges in Developing Countries

The concentrated ownership structures observed in many developing countries have implications for the type of reforms that are required to improve corporate governance. Firstly, it

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7 Chakrabarti, Megginson and Yadav 2007.
8 CIPE 2002, p. 4.
9 Chakrabarti, Megginson and Yadav 2007, p. 10.
10 Sarkar and Sarkar, p. 29.
11 Berglof and Von Thadden 1999.
implies that transplanting laws from countries such as the U.S. will most likely not have the desired effect. Legal reforms need to be designed that tailor the country’s specific needs.  Other problems regarding corporate governance in developing countries are the scarcity of competent directors capable of making informed and objective business decisions as well as the prevalence of low standards of transparency and disclosure and weak shareholders rights. Moreover, in family-owned businesses and especially pyramidal structures minority shareholders can be expropriated, which will be discussed below.

A more severe problem developing countries face is the absence of an effective institutional environment, which is much more time consuming and costly to implement than legal rules. Good corporate governance can only be achieved when a set of democratic institutions is in place, especially a predictable, equitable, effective and efficient legal system in order to enforce corporate governance measures. The institutional framework is essential for entrepreneurs’ ability to attract external financing, as investors must be assured that the assets they provide will be protected. Weak or non-existent property rights, contract violations, a poorly regulated banking sector, long bankruptcy procedures and insufficient punishment involve transaction costs, and in a broad sense lost investment opportunities. In addition, in many developing countries courts are perceived to be inexperienced or corrupt. These deficits in the rule of law contribute to the corporate governance problem, revealing the need for reform at a much broader level: a need to narrow the gap between ‘law in the books’ and ‘law in practice’, an undertaking many developing countries lack the resources or political will for.

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14 Cooper, p. 4
18 Cooper 2007, p. 3
1.3 The Corporate Sector in India

In India the majority of companies, even the listed ones, are family controlled closely held companies. The controlling shareholder is usually also involved in the management. The family owned business structure often brings along more problems such as the lack of transparency and public disclosure of company operations, less professionalism on boards of directors and more corruption. Gupta and Verma point out that these problems are worsened due to “the implicit acceptance that corporate entities belong to founding families”. In case of pyramidal structures minority shareholders can be expropriated even more, since the ultimate owner can control the company while only bearing a small fraction of the financial consequences.

Overall, in the “insider model” prevalent in India there tends to be relatively weak shareholder and creditor protection, not enough disclosure and transparency and little monitoring by majority shareholders. Not surprisingly, Indian corporate governance in practice was considered, according to Dharmapala and Khanna, “weak and quite dysfunctional” until about a decade ago. As explanations for observed events such as insider trading, price manipulation, misuse of bank funds, refusal to pay dividends, companies vanishing with the investors’ money and non-performing assets Gupta and Verma name the lack of (professional) ethics, the passivity of institutional investors and the inadequate powers of Sebi and other compliance authorities.

The World Bank in her Corporate Governance Country Assessment of India in 2004 suggested several reforms, the first being that “Sanctions and enforcement should be credible deterrents to help align business practices with the legal and regulatory framework, in particular with respect to related party transactions and insider trading”. Other recommendations for reform concerned the fragmented

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19 Chakrabarti, Megginson and Yadav 2007.
regulatory structure, the strengthening of board practices and the role of institutional investors in India.

1.4 Enforcement Mechanisms

An extensive literature is devoted to what constitutes the optimal mix of public and private enforcement mechanisms. Whereas private enforcement depends on initiatives of private parties, public enforcement relies on the government acting as the prosecutor. The answer to the question which of those is to be preferred is to a large extend determined by the information, incentives and resources of private parties. The institutional environment to support the mechanisms is also of great importance, making public and private enforcement mechanisms complements rather than substitutes. It has to be considered whether or not a certain governance mechanism can be impacted by policy, in addition to being potentially important.25

1.4.1 Private Enforcement Mechanisms

Rubin (1994) and Berglof and Claessens (2005) identify three types of private enforcement mechanisms, which they call private ordering. Unilateral ordering refers to reputation building or other efforts of companies to improve their commitment power. Bilateral ordering involves strengthening the commitment by two contracting parties, for instance through control-oriented investments in the other company or the exchange of “hostage assets”. Such specific covenants between private parties can help to overcome problems of incompleteness in the legal system and inexperienced courts. Multilateral arrangements finally, according to Berglof and Claessens the most important mechanisms, are customs, trade associations and other institutions with which companies bond themselves to good corporate governance practices. Stock exchanges’ listing requirements which allow companies to signal higher corporate governance standards form a good example. Often these institutions are backed up by self-regulatory organizations for conflict

resolution, such as arbitration courts, as well as by intermediaries that disperse information, exploit economies of scale and prevent free riding in enforcement.

**Box 1: Private Enforcement Mechanisms**

**Self-governance** – Self-governance entails that enforcement is realized without the interference of institutions such as courts, a regulator or other public authorities. Self-governance can be successful in situations where parties have information about each other and are involved in repeated interactions, so that reputational effects are strong.\(^{26}\)

**Reputation** – Reputational effects can restrain companies from violations through the “shaming effect” they have via reputational networks.\(^{27}\) Such reputational effects can be strengthened by disclosure requirements or by third parties such as active investors and consumers, credit rating agencies and the media.

**Investor activism** – Active investors can organize themselves in order to provide guidance and give a voice to shareholders’ concerns.

**Credit rating agencies** – Rating agencies can provide clear incentives for good governance by including governance issues in their rating criteria, thereby affecting companies’ cost of capital.\(^{28}\)

**Media** – The media can support enforcement, in a narrow sense by gathering and disseminating information and in a broad sense by making corporate governance an issue of public debate, thereby helping to establish behavioural norms.\(^{29}\) In addition, close press coverage promotes even-handed enforcement of the law by making this more transparent to the public.\(^{30}\)

**Stock exchanges** – Reforming listing rules is often easier than changing laws. Moreover, the threat of delisting provides stock exchanges with unique self-enforcement abilities.\(^{31}\)

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\(^{26}\) North 1990.

\(^{27}\) Nenova 2005, p. 197.


\(^{29}\) OECD 2003, p. 43.

\(^{30}\) Dyck and Zingales 2003.

**Lending institutions** – Banks have self-enforcement capabilities in the form of refusing to extend additional credit to companies that do not meet the governance criteria. They can be good monitors because they engage in dealings, have reputations to maintain in lending and can economize on enforcement technology.\(^{32}\)

**Bilateral agreements** – Agreements between shareholders, covering issues such as board representation, disclosure of information and procedural rules regarding control and party related transactions, can be drafted more precisely than the existing legal system, thereby overcoming both incompleteness and problems of inexperienced courts.\(^{33}\)

**Private law enforcement** – Shareholders can be granted procedural rights that enable them to initiate suits seeking redress for breach of their rights. In derivative lawsuits one or more shareholders file suit on behalf of the company against the directors to recover losses suffered by the company. Class action lawsuits lower the burdens on individual plaintiffs and ease access to courts, allowing a group of shareholders to file suit directly against the directors or others.\(^{34}\)

**Arbitration** – Arbitration can provide an alternative to enforcement by courts.

Private enforcement mechanisms face several challenges. To begin with, unilateral ordering relies on future transactions, which may not be valuable enough to a party to deter violations, especially in countries where uncertainty decreases the discounted value of such future transactions. More generally, some form of public enforcement may still be necessary for private enforcement mechanisms to be effective.\(^{35}\) This obviously holds for private law enforcement, but also arbitration is less valuable when the general enforcement environment is weak, and self-regulatory agencies in many cases derive their power to regulate from public law.\(^{36}\) Another reason public enforcement may be necessary as a backup, is that private enforcement

\(^{33}\) Berglof and Claessens 2004.  
\(^{34}\) Millstein 2005, p. 10.  
\(^{35}\) Berglof and Claessens 2004.  
\(^{36}\) Millstein 2005.
mechanisms are usually very limited in their sanctioning options, compared to the range of sanctions the government has at its disposal.

Even if private mechanisms operate completely independently their application is cheaper and easier if the law has mandated a clear standard without much room for judge discretion, so that a case can be proved more easily and the outcome is more certain in advance. In the literature this has been referred to as the need for ‘bright line’ rules.\(^\text{37}\) It has also been suggested to design laws that agree with prevailing custom whenever possible, so that there will be more willingness to privately enforce them.\(^\text{38}\) When private parties have an information advantage it is socially preferable for them to initiate enforcement rather than the government spending resources information gathering.\(^\text{39}\) However, also in the presence of bright line rules private enforcement can turn out to be ineffective, since private parties may lack the incentives to monitor and sanction. This is more likely to be the case when private parties would have to exert substantial effort to identify the violator, or even the violation itself, or when they have to work together. Collective action becomes all the more difficult as more parties are involved due to free-rider problems. Class-action suits can overcome these problems, although they bring along the risk of excessive or frivolous litigation. According to Shavell (1993) it is likely that in most cases incentives of private parties to enforce will either fall short or exceed the optimal level, making public enforcement relevant as well.

1.4.2 Public Enforcement Mechanisms

It is thus established that public enforcement may be required in situations where information, incentives or sanctioning options of private parties to proceed with action are lacking, especially when activities have an impact on general public interest and market confidence. Public enforcement of corporate governance includes various aspects: legislative authorities can incorporate governance codes into corporate law, enhance procedural rules,
defences and disclosure requirements in corporate law, improve creditor protection and reform bankruptcy procedures. Regulators and courts, responsible for the actual implementation and enforcement, can be strengthened by the government in terms of capacity and legal powers.

A number of issues associated with enhancing enforcement have been discussed extensively in the literature, such as i) problems of corruption ii) the lack of political will to reform, iii) the need for an effective institutional environment and iv) the optimal extensiveness of the law. These issues are briefly discussed, followed by the proposal of sanctions as an alternative tool to enhance the effectiveness of enforcement.

1.4.2.1 Corruption

Many authors have emphasized the importance for enforcement of independent, well-staffed regulators. However, especially in weak institutional environments there are limits to the benefits of stronger regulators, since more extensive powers may result in more corruption, which lowers enforcement effectiveness and increase the costs of motivating and monitoring bureaucrats. Therefore, strengthening institutional capabilities needs to go hand in hand with hiring well-qualified officials, training them and paying them adequate salaries. Also, campaigns to fight corruption and increase transparency can help to develop confidence in courts and government agencies among the public. However, developing countries may lack the resources to implement such policies.

1.4.2.2 Political Economy

Not only resources but also the political willingness for reform may be absent. The decision to improve CGR enforcement is ultimately the outcome of a political process, which may be a function of the relative bargaining powers of different interest groups, as suggested by public choice theory. If politicians are not benevolent but vote maximizing, they will implement

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40 Berglof and Claessens 2004.
41 Barth, Caprio and Levine 2000.
42 Raval 2011, p. 23.
the regulation favouring the most powerful interest group. The capture theory predicts that industries will ‘capture’ the supervising regulator, to the detriment of the public.\textsuperscript{44} In short, improving the regulatory enforcement also depends on the integrity, independence and professionalism of leaders.\textsuperscript{45}

1.4.2.3 Institutional Environment

In order for all the aspects of the institutional framework to be effective, often the general administrative and enforcement capacity needs to be enhanced. The institutions that need to be in place for the financial market to fully develop are numerous, ranging from property rights, contract rights, bankruptcy systems and taxation regimes to developing competent and experienced courts, regulating the banking sector and promoting competitive markets.\textsuperscript{46} However, reforming all these institutions is a very costly and time consuming activity, while enforcement problems often arise in the first place because of a lack monetary and human resources.\textsuperscript{47} For developing countries a typical ‘chicken and egg problem’ emerges: how to improve the institutional environment without the required financial resources, when the only way to obtain such resources is by financial development, which itself presupposes a well-functioning institutional environment? One solution that has been suggested concerns the extensiveness of legal rules.

1.4.2.4 Extensiveness of the Law

Empirical evidence supports the view that differences in the level of enforcement rather than in the content of the law can explain why countries with similar substantive laws on corporate governance show varying rates of financial development.\textsuperscript{48} Still, opinions vary on the exact function it has for economic growth and what the importance of written law is relative to

\textsuperscript{44} See for an overview Mackaay 1999, pp. 88-91.
\textsuperscript{45} OECD 2003.
\textsuperscript{46} CIPE 2002.
\textsuperscript{47} OECD 2003.
\textsuperscript{48} Sarkar and Sarkar 2012, p. 31.
its enforcement. Some defend that the written law has no independent function at all, while others argue that the extensiveness of the written law affects the scope for enforcement. It has also been pointed out that effective enforcement is not just required to address violations of the law, but also to fill in ambiguities and gaps that the law leaves open. Coffee (2007) argues that more enforcement, while lowering a country’s cost of capital, may also deter foreign investors from cross listing in that country.

Posner (1998) put forth the “rules-first” strategy, meaning that developing countries should initially focus on implementing clear rules that do not require much interpretation by courts, before reforming their judiciaries, since the latter is much more costly and according to Posner, economic growth can be achieved without much law. The OECD (2003) also recommends policymakers to balance the sophistication of rules and procedures with their ease and cost of implementation. A more sophisticated rule may be violated more often due to uncertainty on the side of private parties and may be more difficult to evaluate in court, raising enforcement costs. Clear codes on the other hand, while reducing uncertainty, ambiguity, discretion and opportunities for subversion of law, might be more strict and therefore violated more often, also increasing enforcement costs.

1.4.2.5 Sanctions

Sanctions can also be a tool to enhance enforcement, as well as a consideration in the choice between enforcement mechanisms. Public enforcement allows for the imposition of strict sanctions such as fines and imprisonment, whereas private enforcement mechanisms can often only be backed up by reputational sanctions. Chapters 2 and 3 elaborate on the exact role sanctions play in the various enforcement mechanisms.

50 Berglof and Von Thadden 1999.
51 Millstein 2005.
53 Immordino and Pagano 2003.
1.4.3 Evaluation

Various studies have attempted to weigh private and public enforcement mechanisms against each other in order to find out which one is to be preferred. The conclusions of such conducts have been that i) the impact of enforcement mechanisms is hard to study empirically, ii) public and private enforcement are complements rather than substitutes and iii) their relative importance is affected by path-dependence.

1.4.3.1 Empirical Findings

Empirical research on the efficiency of enforcing institutions is complicated by the difficulty of measuring inputs and outputs. Still, several studies have been conducted on the effect of enforcing institutions on financial development, with varying conclusions. Whereas La Porta et al. as well as the World Bank have identified private enforcement as the central mechanism for corporate governance, Jackson and Roe (2009) believe that the former have dismissed public enforcement of securities laws as unimportant too hastily. Their analysis shows that public enforcement, although not always, produces better financial outcomes and they provide several explanations for this result. The public authority can address general problems that require regulation, investigate individual companies, bring (criminal) enforcement actions and revise rules when necessary. Moreover, its target is not limited to combatting tunnelling and other corporate governance related issues, but also includes building a strong securities market.

1.4.3.2 Mechanisms as Complements

Jackson and Roe (2009), Coffee (2007) and Immordino and Pagano (2003) conclude that the enforcement mechanisms are complements rather than substitutes, as both have defects as well as advantages. Whereas public agents might have weak incentives and limited information, private enforcement mechanisms face collective action and free rider problems, often have to deal with inefficient judiciaries and rent seeking lawyers and are limited in the possibilities to

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54 Berglof and Claessens 2004, p. 25.
impose sanctions, which ultimately may make them dependent on public enforcement.\textsuperscript{56} Berglof and Claessens (2004) underscore this, stating that the role various enforcement technologies play, partly depends on their need for backing by another technology to make them credible. Some mechanisms, such as administrative fines and orders, can be imposed by regulatory bodies while other mechanisms, like injunctive relief and criminal penalties, require a determination of wrongdoing by courts. In short, the capabilities of a particular legal system need to be taken into account when designing CGR. When regulators and courts are still developing, shareholder-triggered mechanisms are essential.\textsuperscript{57} According to the CIPE Report (2002), the development of market-oriented and self-enforcing procedures that do not impose a higher burden on companies and on the government can be achieved by ensuring cooperation between the public and private sector in designing rules.

1.4.3.3 Path Dependence

Berglof and Claessens (2004) stress the role of path dependence in the choices among enforcement mechanisms. An enforcement technology may remain used for a long time after more efficient technologies have become available, due to institutional reluctance to change.\textsuperscript{58} Culture can also be relevant for the choice for a certain enforcement mechanism. For instance, Asian business cultures prefer quiet, informal dispute resolution to court proceedings. That way all parties involved can “save face” and keep their business affairs out of the public eye.\textsuperscript{59} Gupta and Verma make a similar argument regarding the governance system that is in force.\textsuperscript{60} Whereas the Anglo-Saxon countries have a market based, outsider-controlled system, Japan and Germany are used to a more relation-based or insider-controlled system. Relationship-based systems rely on reputations, which are largely self-governing, whereas in a market-based system explicit contracts play a central role. The latter, often found in countries with a common-law tradition

\textsuperscript{56} Nenova 2005.
\textsuperscript{57} Berglof and Claessens 2004.
\textsuperscript{58} Berglof and Claessens 2004, p. 27.
\textsuperscript{59} OECD 2003, p. 30.
\textsuperscript{60} Gupta and Verma 2004, p. 55-58.
such as India, rely more on enforcement of contracts. Berglof and Von Thadden (1999) add that corporate law has been shaped by existing financial structures. A tradition of strong bank involvement in corporate control, such as in Japan and Sweden, is often reflected in legal practice. Similarly, in countries where closely held companies predominate, legislators and regulators have often found it unnecessary to regulate the composition of boards of directors.

Overall, private enforcement appears to have advantages in information, whereas public enforcement tends to have more sanctioning possibilities, making them complements rather than substitutes. Ultimately, their relative importance will depend on the legal, financial, political and cultural environment of the particular country.
CHAPTER 2  CORPORATE GOVERNANCE REGULATION IN INDIA

Attention for corporate governance spurred in India in early 1990s, due to a number of economic developments. Firstly, companies were falling behind in investment and growth rates, relative to foreign competitors. Secondly, attempted hostile takeovers raised legal and policy questions about the rights of shareholders and responsibilities of directors. Moreover, corporate executives received increasing compensation packages while various corporate frauds both inside India and in the rest of the world came to light. As a response to these developments the Indian government started amending laws and installing numerous committees towards good corporate governance.61

2.1 Regulatory framework

2.1.1 Acts

The following statutes form the basis of the corporate governance framework in India:

Securities Contracts (Regulation) Act 1956 (SCR Act) – The SCR Act 1956 controls the securities, areas for trading, licensing of stock exchanges, constitution and governance of stock exchanges and listing agreements. The Act has been amended several times, for instance in 2004 with the demutualization of stock exchanges, and latest in 2007.

SEBI Act 1996 – The SEBI Act 1996 was introduced to protect investors in securities, promote development and regulate securities market in India. It provides the duties of the Securities and Exchange Board of India (“Sebi”), which include regulating intermediaries, takeovers, issue of capital and stock-exchanges as well as preventing insider trading, unfair trade practice and market manipulation.62 The mandate of the Sebi will be further explained below.

Companies Act 1956 - The Companies Act 1956 regulates the incorporation and administration of companies. It has been amended by the Companies (Amendment) Act 2000

and the Companies (Amendment) Act 2002. Further amendments proposed in the Companies (Amendment) Bill 2003 were withdrawn under the pressure of the business sector. In 2009 a new act was drafted, the Companies Bill 2009, to which changes were drafted in 2011 (Companies Bill 2011). The latter is currently pending at the Parliament.63

**Depositories Act 1996** – The Depositories Act 1996 (“Depositories Act”) regulates the function of depository institutions in the Indian securities market. It made dematerialization of share certificates possible, which significantly lowered the time and risks associated with the share trading process.

**2.1.3 Corporate Governance Provisions**

Over the years, a number of committees have suggested recommendations for corporate governance reform. The Confederation of Indian Industries (CII, 1998) consisted of a voluntary set of recommended governance norms that companies could adopt and be seen as being well-run companies. A year later, the Kumarmangalam Birla Committee set-up by Sebi carried out recommendations in line with global developments, such as a separate management report and independent directors. Their recommendations became effective as Clause 49 of the Listing Agreement through the Companies (Amendment) Act 2000.64 In 2002, the Naresh Chandra committee suggested recommendations on disclosure norms, fiduciary responsibility of directors, independent auditing, board composition and auditing standards which were carried out by the Ministry of Corporate Affairs (then still called the Department of Company Affairs). The revised Clause 49 was reviewed by the N.R. Narayana Murthy Committee, constituted by Sebi. The inclusion of Clause 49 in the Listing Agreement aimed at driving in a minimum standard of corporate governance among listed companies in India. Its key mandatory recommendations relate to the need for independent directors and their remuneration, an audit committee, management discussion & analysis reports and better disclosure norms towards the shareholders,

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See Box 2. The recommendations are applicable to all listed companies, their directors, managers, employees and associated professionals. The managers and directors are responsible for putting the recommendations into practice.

Box 2: Mandatory recommendations in Clause 49

**Board of directors:** Listed companies worth more than Rs. 25 crores or paid up share capital greater than Rs. 3 crores and their subsidiaries must have either a majority of independent directors, or at least 1/3 independent directors plus a board chairman who is not the CEO. An independent director is defined as a non-executive director who does not have any pecuniary relationship or transactions with the company, or its promoters, or its senior management and its holding or subsidiary company. The recommendations also specify limitations on the directors’ compensation.

**Board practices and processes:** Directors’ terms can be maximum five years, provided that they either have annual terms or terms of at least two-thirds of the directors are staggered, with a maximum of 3 years. The board must have at least 4 board meetings per year with at most 3 months in between, for which minutes must be prepared.

**Audit committee:** Companies and their subsidiaries are required to constitute a qualified and independent audit committee, which has at least one member with expertise in accounting or finance and meets at least 4 times a year. This committee should review, among other things, financial statements, management discussions, risk management reports and records of related party transactions.

**Disclosure requirements:** Disclosure requirements relate to the use of accounting principles, related party transactions, risk management, the use of the proceeds of an IPO. Also, an internal control system for the reported financials must be in place.

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65 A more detailed overview can be found in for example Balasubramanian, Black and Khanna 2009.
66 Gupta and Verma 2004, p. 17
<table>
<thead>
<tr>
<th>Shareholder rights:</th>
<th>Shareholders holding at least 10% of the shares can call a special shareholder meeting. Shareholders also have the right to ask Sebi to investigate the controlling shareholder in case of oppressive behaviour.</th>
</tr>
</thead>
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<tr>
<td>Code of Conduct:</td>
<td>A Code of Conduct must apply to all board members and senior management.</td>
</tr>
<tr>
<td>Whistle Blower Policy:</td>
<td>Employees who observe any unethical practice in the company should be able to take this to the audit committee without their supervisors knowing about it.</td>
</tr>
</tbody>
</table>

2.2 Regulators

The three main agencies are Sebi enforcing securities law, the Ministry of Corporate Affairs (MCA) administrating the Companies Act, with the Company Law Board (CLB) as its enforcement arm, and the stock exchanges regulating the listing agreements.

2.2.1 Sebi

The Securities Exchange Board of India (Sebi) was set up in 1988 as an advisory body and was granted authority to regulate the securities market under the SEBI Act of 1992. Sebi’s role includes regulating business in stock exchanges and other securities markets, regulating financial intermediaries, prohibiting insider trading and fraud, promoting investors’ training and inspecting various regulated entities. Its stated objectives are to protect the interests of investors, to ensure the fairness, integrity and transparency of the securities market and to promote its development, to ultimately reach best international regulatory practices.

Sebi has the power to issue subordinate legislation and is empowered to adjudicate on the violations found during inspections and investigations, or by the information provided by investors, intermediaries and media (Section 11(c)(1) SEBI Act, 1992). When a violation is found, directions can be issued, registration can be cancelled or suspended and monetary penalties can

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67 Black et al. 2010.
68 Kaushik and Kamboj 2011.
69 Goyal 2005,
70 Kaushik and Kamboh 2011
be imposed. The Securities Appellate Tribunals (SAT) with specialised domain knowledge can review ’s regulatory actions.\textsuperscript{71}

Sebi’s tasks and powers have expanded over time, for instance under the SEBI (Amendment) Bill 2002, when Sebi was empowered to call for information from non-intermediaries and to seize documents for evidence, and in 2003 when Sebi was empowered to impose enhanced monetary and criminal penalties.\textsuperscript{72}

\textbf{2.2.2 MCA and CLB}

The CLB is responsible for the enforcement of the Companies Act. According to Section 209A of the Companies Act the Registrar of Companies is empowered to inspect the books of accounts of companies with respect to their compliance to the Companies Act, the accuracy of their accounts and the statutory auditor’s inspection, the use of their funds (not for private gains) and honouring of the rights of minority shareholders. In case of failure to file the accounts or if another violation is found, the CLB is authorized to initiate legal proceedings against the company.

\textbf{2.2.3 Stock exchanges}

There are 24 stock exchanges active in India’s capital market, which have grown rapidly over the last three decades, especially after India opened up to foreign investments. The set-up of the National Stock Exchange (NSE), an automated electronic exchange, substantially enhanced the transparency and liquidity of the stock exchanges and quickly gained upon the Bombay Stock Exchange (BSE). Stock exchanges are empowered to define additional rules and have the responsibility of enforcing the listing regulations, but are not authorized to impose fines. (Section 4 and 9 SCR Act, 1956). Rules must be improved by Sebi, which is also the institution to take up enforcement cases identified by stock exchanges (Section 8 SRC Act, 1956).\textsuperscript{73}

\textsuperscript{71} Sarkar and Sarkar 2012.
\textsuperscript{72} http://www.sebi.gov.in/web/home/list/1/1/0/0/Acts. Last visited on 06/08/2012.
\textsuperscript{73} Raval 2011
The efficiency of the regulators, more particularly Sebi and the CLB, will be discussed in Chapter 5, in which data is provided of the performance of the regulators with respect to disposal of cases, imposed sanctions and the conviction rate.

2.3 Derivative Suits and Class Actions

Derivative liability and class actions are briefly discussed because of their relevance for the effectiveness of private enforcement.

Derivative liability entails that a group of shareholders that represent a certain percentage (usually 10) of the shares can sue directly for damage caused to the company. In India derivative suits are allowed, but rarely used.\textsuperscript{74} According to Khanna and Varottil (2012) the reason lies in the legal, judicial, economic and cultural environment in India.

Class action rights lower the burden for groups of individuals to initiate legal proceedings. The Companies Bill, 2009 introduced a specific clause (Clause 245) on class actions by shareholders. However this was met with stiff resistance from the industry which feared having to face a large increase in lawsuits from shareholders. The government as a response substantially limited the provision, making it less likely that it will result in greater enforcement of corporate law through increased shareholder actions. One important advantage of the provision is that it places shareholder actions within the jurisdiction of a specialised court with more knowledge in the field.\textsuperscript{75}

\textsuperscript{74} Doing Business 2012.
\textsuperscript{75} [http://indiacorplaw.blogspot.in/2011/12/companies-bill-2011-class-actions.html](http://indiacorplaw.blogspot.in/2011/12/companies-bill-2011-class-actions.html) Last visited on 06/08/2012.
CHAPTER 3 LITERATURE ON THE ECONOMIC THEORY OF PUNISHMENT AND DETERRENCE

In this chapter various variants of the economic model of punishment and deterrence are listed, followed by its limitations and the specific problems associated with punishing corporate crime. The link between corporate crime and CGR is examined, after which the for CGR enforcement relevant parts of the corporate crime literature will be touched upon. The chapter will finish with a brief discussion of the implications for the use of private enforcement mechanisms.

3.1 Deterrence Hypothesis

The deterrence hypothesis refers to the proposition that crime rates respond to risks and benefits, or more particularly, to deterring incentives created by the criminal justice system. The seminal paper is Becker (1968), who posits that offenders are rational utility maximizers, whose decision on whether or not to commit a crime is based on the expected punishment costs and the expected gain of the crime. According to this hypothesis, the government can affect the decision of the offender by altering the expenditures on crime-control as well as the severity of the sanctions. The main result of Becker’s paper, and also the controversial one, is that the optimal level of the fine is maximal and the optimal probability of detection is low, since crime-control is costly but raising the sanction is not. Hence, as long as the fine is not maximal, deterrence could be increased at no cost. The maximum, and optimal, level of the fine equals an individual’s wealth, and only if this does not deter sufficiently, the fine should be complemented with the appropriate probability of detection. Since both enforcement and underdeterrence are costly, the probability of detection should be increased as long as its marginal benefits (reducing harm)

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76 Garoupa 1997.
77 A formal model will be provided in Chapter 4.
78 Polinsky and Shavell 2000a.
79 Garoupa 1999; Garoupa 1997
exceed its marginal costs (enforcement expenditures).\textsuperscript{80} If individuals are risk averse, the optimal fine is generally less than maximal, since greater risk-bearing leads to a decline in fine-revenue, which could more than offset the savings in enforcement expenditures from reducing the probability of detection.\textsuperscript{81}

Following the same reasoning, the optimal imprisonment term too is maximal when individuals are risk neutral. When the imprisonment term is raised while the probability of detection is lowered so as to keep the expected sanction constant enforcement expenditures fall. This is even more so when individuals are risk averse in imprisonment, since in that case the probability of detection can be lowered even more without reducing deterrence. With imprisonment as a sanction, more underdeterrence may be optimal than is the case with fines, since not only enforcement expenditures, but also costs of imposing imprisonment terms can be saved with a lower detection probability. Put differently, the optimal probability is different since the marginal costs of increasing enforcement are higher than is the case with fines.

When a combination of fines and prison term is imposed, the optimal fine is still the maximum fine but the optimal imprisonment term may be lower than the maximum. This is because a lower detection probability now not only affects deterrence of imprisonment but also deterrence of fines, which means it cannot fall proportionally, as before. Raising the imprisonment sanction is then only efficient if savings in enforcement costs are sufficiently large.\textsuperscript{82}

The deterrence hypothesis has been extended in numerous ways, such as using a fault liability standard rather than strict liability, letting wealth vary among individuals (Polinsky and Shavell 1991), including costs of executing fines (Polinskky and Shavell 2000, Kaplow 1990), including a choice in criminal activity level (Polinsky and Shavell 2000), including the effect that imprisonment takes away the option to commit crimes (Shavell 1987), including the effect of

\textsuperscript{81} Polinsky and Shavell (1979), Kaplow (1992).
\textsuperscript{82} Polinsky and Shavell 1999 p. 11-12.
avoidance activities (Malik 1990) and considering the effect of judicial errors (Png 1986). A detailed discussion of those and other extensions can be found in Eide (2000).

3.2 Limitations

The economic theory of punishment has been criticized for a number of reasons. Firstly, it has been subject to the general criticism on the expected utility framework and rationality assumptions. Criminals may not be led by rationality considerations but by the norms they internalized and the groups they are part of. Also, the inclusion of an inter-temporal dimension and strategic behaviour may alter the outcomes, in the sense that criminal deterrence may turn out to be weaker. Criminals may respond to perceived changes, which may differ from actual policy changes. Cameron criticizes the presumption that punishment would deter at all. He names a number of economic reasons why this would not be the case, such as the fact that legal activities can be risky too, that deterrence might just shift criminal activity to a different sector or that fines might drive criminals into more criminal activity in order to pay for them. Garoupa (1999) points out that the relation between the optimal fine and optimal detection probability is one of complementarity rather than substitutability at low levels of deterrence. At that point it is only worthwhile for governments to spend money on detection when the fine that will be imposed is substantial. Wilde (1992) looks for reasons why in practice severe criminal sanctions are imposed, despite Becker’s result that a high expected sanction should be sufficient to deter all crime. He proposes a model with a richer set of action choices and consequently a more complex relationship between deterrence and crime.

Garoupa (1997) concludes that “even though highly criticized, the theory of law enforcement and the economics of criminal law constitutes a body of literature which has contributed to the understanding of crime, its deterrence and prevention […] [and has] a limited though crucial role to play in Criminology.”

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84 Garoupa 1997, p. 288.
3.3 Corporate Crime

The critique on the deterrence hypothesis is largely aimed at the rationality assumptions but for many types of corporate crime these rationality assumptions can be much better defended. Corporate crime is defined to include fraud, environmental violations, antitrust and product quality violations, or even broader, as is generally done in law and economics literature, also including corporate torts. Among those, the most relevant type for the discussion of corporate governance is fraud. Insider trading for instance involves one or more calculative, planned activities aimed at monetary gain. For such rational activities it appears not unreasonable to assume that changes in sanctions or detection probability affect individuals' behaviour. Put differently, despite the critique the deterrence hypothesis is still valuable for the field of corporate crime. This section sheds light on the distinguishing aspects and problems associated with corporate crime, after having established the common ground with CGR. At the end of the section the implications for the role of private enforcement are discussed.

3.3.1 Corporate Crime and Corporate Governance

Usually, CGR specifies requirements companies need to comply with, whereas in cases of fraud harm already has been done. In this view CGR can be considered a form of prevention against fraudulent activities, whereas (criminal) sanctions for such activities can be assumed deterrents. The existence of such a connection is supported by empirical studies, at least for the United States, which find that more independent board members and audit committee meetings are associated with a lower number of fraud cases, that fraud likelihood is lower when board and audit committee members are all independent directors and have fewer directorships with other companies, and when the CEO is not chairman of the board. Overall, fraud companies tend to have poorer governance than companies where fraud has not occurred.87

Legally the distinction between CGR enforcement and corporate crime prosecution vary among countries. Some countries treat the two completely separately in both their laws and their

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enforcement.\textsuperscript{88} In India however, corporate governance regulation and some parts of corporate crime, such as insider trading, are enforced by Sebi. Moreover, in India regulation of insider trading is viewed as essentially being part of corporate governance.\textsuperscript{89} The distinction is therefore less important when looking at India, and moreover, the distinction is less relevant for an economic analysis of the effect of sanctions. Namely, regardless of whether an offence can be identified as a CGR violation, a corporate crime or perhaps both, if the sanction is the same so will be the effect on the violator’s behaviour. Put differently, deterrence through sanctions can be regarded as a tool that can be applied to CGR in the same way as corporate crime.

For the remainder a violation, a crime or an offence committed by a company or manager will refer to CGR, unless specified otherwise. The next section covers the features of the deterrence model when applied to corporate crime, in order to distillate the for CGR enforcement relevant aspects.

\textbf{3.3.2 Modelling Corporate Crime}

A corporation is distinct from an individual in the sense that a company is a hierarchical group of individuals. Therefore, with respect to sanctioning new questions arise namely what individual within the company sanctions should be targeted and whether or not the company as an entity should be targeted too, or alternatively.\textsuperscript{90}

The model generally used to address these problems is the principal-agent model.\textsuperscript{91} Corporate crimes are not committed by companies but by managers (agents) of the company, and generally not in the interest of the shareholders but in managers’ own interests.\textsuperscript{92} Some argue that when harm is caused by the behaviour of principals and agents, many of the conclusions simply carry over to the sanctioning of principals, who will as a response monitor and discipline

\textsuperscript{88} In the Netherlands for instance, corporate crime is sanctioned in the Criminal Code together with a specific criminal code on economic crimes, whereas the corporate governance regulation is codified separately and is enforced by a special monitoring commission.

\textsuperscript{89} www.lawyersclubindia.com/articles/print_this_page.asp?article_id=3446, last visited on 20-07-2012.

\textsuperscript{90} Mullin and Snyder 2007, p. 1.


\textsuperscript{92} Garoupa 2000, p. 244. See also Arlen 1994, p. 834.
their agents. If this is the case, it does not matter who the government directs the sanction at, since a type of Coasean bargaining process will lead to the optimal result either way.  

It has also been pointed out that companies usually have better information and could therefore be the “superior sanctioner”.  

However, companies cannot fully control their agents. They can monitor them, but this involves agency costs. Moreover, just as the corporation is not an individual the shareholders are neither, resulting in collective action and free-riding problems that may limit the shareholders’ incentives to monitor. Hence, it is no longer irrelevant how the government divides the sanction between the principal and the agent. Overall, to optimally deter agents' wrongdoings, corporate liability the government must both regulate levels of criminal activity and induce the company to implement enforcement measures.

3.3.3 Target of the Sanction

Provided that a sanction can generally not be reassigned by private parties according to a Coasean bargaining process, it must be assessed what other factors determine which participant ought to be sanctioned by the government and what procedure and sanction ought to be used.

It has been stressed that it is efficient that the body best able to control the agent should sanction him, which in many cases will be the principal rather than the state. However, sanctioning a company brings along new issues, such as the range of sanctions that can be carried out on a company. Coffee (1981) describes this as the “deterrence trap”: A company’s resources may be smaller than the amount of fine that would deter it from committing a crime. In case of individuals, the imposition of prison terms may provide a solution, but a corporation obviously cannot be incapacitated. Considering fraud cases, which usually involve very high profits for the fraudulent corporation, difficulties in finding evidence and proving intent, it is not unrealistic to find cases in which the expected gain may be so high, and the likelihood of apprehension so low,

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94 Garoupa 2000, p. 244. See also Arlen and Kraakman 1997.
95 Arlen and Kraakman 1997, p. 95.
96 Arlen and Kraakman 1997, p. 95.
that the only fine that would deter by far exceeds any company’s resources.\(^98\) Fisse (1982) points out that a wide range of other sanctions than fines is available, namely managerial intervention, community service, publicity leading to reputational loss. According to him these fines are not only effective but also more fair than fines because they punish the correct individuals.\(^99\) Another possible sanction is to ban companies from certain markets.\(^100\)

If the corporation is sanctioned and for some reason (such as high costs) does not carry over the sanction internally, corporate crime involves externalities, because the costs of deterrence spill over onto parties who are not culpable, such as shareholders, creditors, employees and customers. Coffee stresses that if this happens, not only does the company go unpunished but also the intended beneficiaries of the criminal law wind up bearing the sanction. He therefore rejects fines directed at the corporation as being inadequate to deter illegal behaviour.\(^101\) Others, such as Byam, make a similar argument but conclude that fines directed at the corporation are for that reason unjust.\(^102\)

Another consideration is which party will be best able to bear the sanction, that is, which party is most judgment-proof. When the sanction exceeds a party’s resources, the party can escape the liability for the unpaid portion.\(^103\) In general the company can be expected to be more judgment-proof than its employees.

### 3.3.3 Enforcement Mechanisms

Also the question whether civil or criminal proceedings are to be preferred in cases of corporate crime has been topic of debate. One of the main benefits of the criminal-law system is the option to incapacitate a violator, which is not possible in case of companies. Byam mentions the extra procedural protection associated with criminal proceedings, which increase the costs of

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\(^100\) Mullin and Snyder 2007, p. 21-22.


\(^102\) Byam 1982, p. 603.

\(^103\) Mullin and Snyder 2007, p. 10.
using this system relative to the civil-law system.\textsuperscript{104} Moreover, the standard of proof maintained in criminal law, “beyond reasonable doubt”, is much higher than the one in civil law. This increases the costs of criminal proceedings even further.\textsuperscript{105} On the other hand, the criminal stigma that is imposed on a convicted corporation may exceed the reputational effect resulting from a civil conviction. According to Byam “the government could use the criminal stigma to save the administrative costs of imposing higher civil levies”.\textsuperscript{106} Empirical research shows that corporations indeed suffer reputational loss after criminal proceedings, measured in terms of leaving clients and employees.\textsuperscript{107} Mullin and Snyder point out that this criminal stigma could also lead to overdeterrence, which introduces a number of social costs.\textsuperscript{108} Bowles, Faure and Garoupa (2008) conclude that criminal enforcement is likely to be relatively more effective in settings where harm is diffuse, the probability of detection low, or defendants are likely to be judgment-proof.

An additional problem of public enforcement, especially in the context of developing countries, is whether or not government officials have the correct incentives. As discussed in Chapter 1, it is not necessarily realistic to assume that officials act in the interest of the government as a whole (problems of corruption), or that politicians aim to maximize social welfare (capture theory). This has implications for the type and level of the optimal sanction.

Firstly, when corruption exists, the optimal fine may be less than maximal, because a higher fine, although deterring crime, encourages corruption.\textsuperscript{109} However, the optimal fine with a malevolent government has to be much higher than the court fees are, so as to prevent corrupt officials from extracting bribes from innocent parties. The higher the court fees, the more scope an official has to ask innocent parties for a bribe in order to avoid such a costly legal procedure.\textsuperscript{110} Conversely, Garoupa and Klerman emphasize the deterring role bribes can play:

\begin{thebibliography}{11}
\bibitem{104}Byam 1982, p. 601.
\bibitem{105}Mullin and Snyder 2007, p. 22
\bibitem{106}Byam 1982, p. 600.
\bibitem{107}Alexander 1999.
\bibitem{108}Mullin and Snyder 2007, p. 22.
\bibitem{109}Becker and Stigler 1974, pp. 5-6.
\end{thebibliography}
when severe nonmonetary sanctions are used officials can extract higher bribes, thus restoring some deterrence.\textsuperscript{111}

Secondly, increasing maximum fines might not be as simple as it appears at first glance, since interest groups might successfully oppose such reforms. This especially holds for CGR, since the corporate sector forms a powerful interest group.

Enforcement by private parties finally, would according to Becker and Stigler (1974) be sustainable when the private enforcer would be entitled, if successful, to retain the entire proceeds of the suit. Landes and Posner state that this idea is only appropriate for a restricted range of situations, and that the existing division of enforcement between the public and private sectors could approximate the optimal division.\textsuperscript{112}

Also from a deterrence perspective the optimal enforcement mechanism has been subject to debate. According to Landes and Posner, optimal public enforcement would be more efficient than private enforcement, but it is not said that public enforcement is always optimal.\textsuperscript{113} Polinsky (1980) argues that public enforcement is socially preferable to private enforcement, even when the former is much costlier, because private enforcement tends to lead to less enforcement. This statement opposes the much heard argument that private enforcement would lead to an excessive incentive to litigate, and consequently, frivolous suits. According to Coffee (1986), private incentives are likely to be suboptimal from a social cost perspective, as a consequence of the fact that class and derivative suits are typically managed by the attorney, who, rather than evaluating the expected benefits of a single case, has a portfolio theory or risk diversification perspective.\textsuperscript{114} Byam advocates private enforcement when an offence has identifiable victims, the victims are aware of the violation and know the violator’s identity, although it is questionable how often this will be the case.\textsuperscript{115} Bowles, Faure and Garoupa take the perspective of crime as an externality and

\textsuperscript{111} Garoupa and Klerman 2004
\textsuperscript{112} Landes and Posner 1997, p. 3.
\textsuperscript{113} Landes and Posner 1997, p. 3.
\textsuperscript{114} Coffee (1986), pp. 676-677.
\textsuperscript{115} Byam 1982, pp. 595-597.
build on the Coasean approach that public enforcement is justified when there are high transaction costs between parties, such as imperfect detection by victims due to collective action problems, the need for enforcement technologies and the need for enforcing the sanction.  

Comparable to the conclusions in Section 1.4, the main considerations when choosing between public (criminal or civil) and private enforcement mechanisms appear to be i) costs (the criminal justice system is very costly to operate), ii) available sanctions (criminal law provides a wider range of possible sanctions), iii) incentives (private solutions face information or collective action problems), iv) technology (affecting private parties’ incentives to enforce) and v) tastes and preferences, in Section 1.4 captured as path dependency.

CHAPTER 4: MODEL OF PUNISHMENT AND DETERRENCE

This chapter provides a formal representation of possible enforcement mechanisms described before, together with a clarification of their advantages and problems.

4.1 The Basic Framework

Suppose a company is made up of a management and shareholders, the former running the business and the latter owning the shares and only being involved in structural decisions. Assume for convenience that the management consists of only one manager. A principal-agent problem exists between the manager and the shareholders, because the shareholders cannot observe the activities of the manager. The manager can harm the shareholders by failing to comply with mandatory corporate governance provisions or by committing corporate crimes that grant him private benefits. Both will be referred to as “offences”. The shareholders can monitor the manager’s activities, but monitoring is costly and requires collective action by the shareholders.

Ownership can either be dispersed or concentrated. In the latter case, and when the majority shareholder is the manager, minority shareholders cannot block manager’s decisions anymore and the manager might extort private benefits to the detriment of the minority shareholders. This situation resembles the one in the family-owned company, the prevailing ownership structure of companies in India.

Suppose the government has put in place CGR in order to establish a minimum standard of corporate governance among companies. In order to assure compliance with the corporate governance regulation the government can sanction companies, their managers or both for offences, using either the civil-law system or the criminal-law system. The government can also grant the shareholders legal rights to sue the manager for damages in the form of derivative suits or class actions. Suppose that the liability standard is strict liability for all violations.\(^{117}\)

\(^{117}\) For a discussion of the implications of the use of a fault liability standard, see for instance Polinsky and Shavell (1999).
The challenge for the government is to design the enforcement mechanism and the accompanying sanction in such a way as to achieve optimal deterrence and to induce optimal monitoring by the shareholders. The following model will provide insight in this optimization problem.

4.2 Sanctioning the Company

4.2.1 Public Enforcement

4.2.1.1 Civil Proceedings

Firstly, this problem will be approached from a macroeconomic point of view, namely one where there are only the government and a company. The company can choose to commit offences which harm society ($h$) but which yield the company private benefit ($b$). Private benefit of companies is distributed according to the distribution function $g(b)$ in the interval $[0,B]$. The state can incur expenses $c_g$ to increase the probability of detection of violations by companies ($p_g, [0,1]$) and it can set the fine ($f_g$) in the interval $[0,F]$. Given $p_g$ and $f_g$, companies will commit the offence if

$$b \geq p_g f_g$$

The state is assumed to be benevolent and maximize social welfare ($W$):

$$W = \int_{p_g(c_g)f_g}^{B} (b - h)g(b)db - c_g$$

Optimization with respect to $f_g$ and $c_g$ leads to Becker’s (1960) well-known results:

i) $f_g^* = F$, since raising the fine is costless while raising $p_g$ is associated with costs $c_g$.

ii) $p_g^*$ is where $c_g$ is at its optimum level, which is where $(b - h)g(b)db = c_g'(p_g^*)$. 


At this level \( p_{gf}^* < h \), showing that some underdeterrence is optimal due to the costs of enforcement. The key result is that it is optimal to raise the fine to its maximum level in order to deter most efficiently.\(^{118}\) As discussed before, the government should only resort to spending resources on increasing the detection probability to the extent that raising the fine does not deter sufficiently.

When it is assumed that individuals are risk-averse rather than risk neutral, the risk premium that the individual bears when he commits a crime represents an extra social cost. Because of this social cost, the optimal fine may be less than the maximal fine.\(^{119}\) Risk aversion can be said to introduce costless deterrence for the government.\(^{120}\)

Now consider the situation within the company. A fine directed at the company is shared between the manager and the shareholders, which means for the manager that he only bears a fraction of the fine \((\lambda)\), with \(0 \leq \lambda \leq 1\). This leads a risk neutral, rational manager to commit a corporate crime if

\[
(3) \quad b \geq p_{gf}^* \lambda F
\]

With maximum fine \(F\) there is more underdeterrence so that costs need to be incurred to raise \(p_{gf}\) and keep deterrence at the same level. The problem with punishing the company is that it is not certain that the sanction will be borne by the violator. Put differently, an offence committed by a member of the company may cause externalities on other stakeholders, as described in Chapter 3. In this model the stakeholders are limited to the shareholders, but obviously also creditors, employees and customers may wind up paying for part of the fine.

\(^{118}\) The maximum level is assumed to equal the violator’s wealth. For an analysis of the implications of differences in wealth among violators, consider for example Polinsky and Shavell 1991.

\(^{119}\) Polinsky and Shavell 1979.

\(^{120}\) Garoupa 1997, p. 279.
4.2.1.2 Criminal Proceedings

Suppose criminal prosecution of the company has two distinguishing features compared to a civil suit against the company:

i) The burden of proof to convict the manager is higher. In addition to detection probability \( p_g(c_g) \) there is also a probability \( q \) of conviction and prosecution costs \( s \), with \( q'(s) > 0 \).

ii) A criminal conviction leads to a reputational loss \( (R) \) for the company due to the criminal stigma associated with it. Hence, next to the fine this reputational sanction is imposed.

A risk neutral, rational manager will commit an offence if

\[
(4) \quad b \geq p_g q(f + R)
\]

The government aims at maximizing social welfare:

\[
(5) \quad W = \int_{p_g(c_g)q(s)}^{b} \left( b - h - p_g(c_g)q(s)R \right) g(b) db - c_g - s
\]

Optimization with respect to \( f_g \) and \( c_g \) leads to the following results:

i) Again \( f_g^* = F \);

ii) \( R^* \) depends on the relative harm and the relative enforcement costs, since reputational sanctions increase the expected costs of an offence for the company but also the enforcement costs of the government are raised. The question is if the enforcement costs are offset by the extra deterrence that reputational sanctions can achieve. Put differently, when the main advantage of criminal proceedings for deterrence, imprisonment, is not available – since obviously a company cannot be incapacitated – it is questionable if this enforcement mechanism is preferable to the less costly alternative of civil proceedings.
4.2.2 Internal sanctions

When the government sanctions the company, it is up to the shareholders, as victims of the crime and stakeholders of the company, to attempt to identify the violator. This could be the efficient solution since the shareholders have an interest in identifying the violator when part of the burden of the fine \((1 - \lambda)\) falls on them and they are likely to have an information advantage over the government. Suppose that the shareholders can impose internal sanctions on the manager if they find out that he has committed an offence, which internal sanction could be monetary (reduce the manager’s bonus) as well as nonmonetary (suspend the manager or remove him from his position). Let these internal sanctions be \(k\), within the interval \([0, K]\) and let the probability that shareholders will detect a violation be \(p_s\), which for now is exogenously given. As long as carrying out the sanction is costless, the optimal \(k\) is \(K\). A risk neutral, rational manager will commit an offence if

\[
(6) \quad b \geq p_s^* \lambda F + p_s K
\]

By increasing the expected costs of committing an offence, internal sanctions by the shareholders can redirect at least part of the fine towards the true violator and thereby also restore (part of) the deterring effect of a sanction directed at the company, depending on the severity of \(K\). This raises the question why the government would not just direct sanctions at the company and let the shareholders deal with identifying and punishing the true violator. The answer to this question is that this form of private enforcement involves some complications, which are discussed below.

4.3 Sanctioning the Manager

The manager, rather than the company, could be identified and sanctioned for offences in the following ways: i) the government initiates civil proceedings against the manager, ii) the
government initiates criminal proceedings against the manager iii) the shareholders carry out internal sanctions on the manager or iv) the shareholders start civil proceedings against the manager.

4.3.1 Public Enforcement

4.3.1.1 Civil Proceedings

When the government initiates civil proceedings against the manager, the situation is back to the initial one in the original setting, which leads to the result that \( f_g^* = F \) and \( p_g^* \) is where \( (b - h)g(b)db = c_g'(p_g^*) \). However, extra detection costs may need to be incurred to be able to identify who within a company is responsible for a certain violation.

4.3.1.2 Criminal Proceedings

Criminal prosecution of the manager has two distinguishing features compared to a civil suit against either the company or the manager:

iii) It is possible to impose the sanction of an imprisonment term \( t \), within the interval \([0,T]\). As opposed to fines, which are assumed to be costless to impose, executing imprisonment introduces social costs \( i(t) \), with \( i'(t) > 0 \). The disutility of imprisonment to the manager is \( z(t) \), with \( z'(t) > 0 \).

iv) Again, the burden of proof to convict the manager is higher. In addition to detection probability \( p(c) \) there is also a probability \( q \) of conviction and prosecution costs \( s \), with \( q'(s) > 0 \).

A risk neutral, rational manager now commits the crime if

\[
(7) \quad b \geq p_g^*q'[f_g + z(t)t]
\]

The government aims at maximizing social welfare:
The government chooses \( f_g, c_g, t \) and \( s \). Optimizing with respect to these variables leads to the following results:

i) Again, \( f_g^* = F \), following the same reasoning as before.

ii) The optimal level of \( t \) depends on the relative marginal harm and marginal sanctioning costs. Higher sanctions have an ambiguous impact on social welfare: they deter more, so that harm decreases and social welfare increases, but the social costs \( i(t) \) of imposing higher sanctions lower social welfare. As a result, the maximum imprisonment term is not necessarily the maximal term.

iii) The optimal level of detection and prosecution probabilities depend on the relative marginal costs of increasing detection, prosecution and sanctioning. When the costs of executing imprisonment \( i(t) \) are positive it may be more efficient to increase expenditures on detection and prosecution than to raise imprisonment terms.

The criminal-law system has the advantage over civil proceedings that the state has recourse to imprisonment as a penalty. However, due to the higher burden of proof, or lower probability of conviction \( q \), this does not necessarily mean that the criminal-law system has a stronger deterring effect than civil proceedings have. Depending on the relative magnitudes of \( q, F \) and \( t \), it may be that

\[
(9) \quad p_g^* q^* [F + z(t)t] \leq b \leq p_g^* F
\]

This is the case if
4.3.1.3 Budget Constraint of the Government

When the budget constraint of the government is included, the result derived above is more likely to occur. Such a budget constraint is especially relevant to include when considering developing countries. As discussed in Chapter 3, the use of the criminal-law system can be assumed to be more costly than civil proceedings because of the costs of prosecution as well as the execution costs of imprisonment. Suppose that the government has a fixed budget \( B \) at its disposal that can be spent on enforcement. If the civil-law system (\( CI \)) is used this budget goes entirely to detection costs \( c_g \), so that \( B = c_g \), whereas for the criminal-law system (\( CR \)) it must be divided among \( c_g, s \) and \( i(t) \) so that \( B = c_g + s + i(t) \). This means that \( p_g, q \) and \( i(t) \) are limited to \( \bar{p}_g^{CI}, \bar{p}_g^{CR}, \bar{q} \) and \( \bar{t} \), with to \( \bar{p}_g^{CI} \geq \bar{p}_g^{CR} \), since \( q \geq 0 \) and \( t \geq 0 \). Now it can occur that civil proceedings are deterring but criminal proceedings are not when

\[
(11) \quad \bar{p}_g^{CR} \bar{q}[F + z(t)t] \leq b \leq \bar{p}_g^{CI} F
\]

Due to the higher burden of proof in criminal proceedings combined with a limited budget to investigate and prosecute violations, civil proceedings could be a more effective deterrent than the criminal prosecution despite the fact that in the former only fines can be imposed. Another problem is that the government might not be malevolent, as discussed in Chapter 3.
4.3.2 Private enforcement

An alternative to state enforcement is to leave the responsibility of enforcement with the shareholders. The effectiveness of such a private enforcement mechanism depends on i) whether or not shareholders have sufficient information to enforce, ii) whether they have the correct incentives to obtain information and enforce and iii) whether the sanctions they have at their disposal are sufficient to deter the manager from committing offences.

4.3.2.1 Information problems

When the shareholders can detect an offence and impose internal sanction $k$ on the manager, a risk neutral, rational manager will commit an offence if

$$ b \geq p_s k $$

Where $k$, in the interval $[0,K]$, is again the internal sanction that shareholders can impose on the manager. However, rather than exogenously determined, as assumed before, the probability of detection is now more realistically determined by the monitoring efforts the shareholders put in. Let $V$ be the value of the shares to the shareholders, which has a certain exogenously defined starting value $V_0$ and is negatively affected by $h$ when the manager commits an offence. Increasing monitoring efforts positively affects the probability of detection $p_s$ in the interval $[0,1]$, but is costly so that $p_s'(c_s) > 0$. Other than the government, that maximizes social welfare (including the violator’s benefit), shareholders maximize their private value:

$$ V = \int_{p_s(c_s)k}^{0} (V_0 - h)g(b)db - c_s $$

Which is optimal when:

i) $k^* = K$, since imposition of the sanction is assumed costless;
ii) \( p_s^* \) is where the extra monitoring costs equal the reduction in the harm: \( h g(b)db = c'_s(p_s^*) \). Beyond that, the shareholders are better off bearing the harm than incurring costs to avoid it. This result differs from the result in the original setting because the violator’s benefit is not included in the shareholders’ optimization problem, while it is included in the social welfare function.

If the shareholders can monitor the manager at costs \( c_s < c_g \), the information is less costly to obtain for them than for the government. Combined with the fact that shareholders do not include \( b \) in their decision, it must be that \( p_s^* > p_g^* \). That suggests that it is more efficient for the state to direct the sanction at the company and let the shareholders monitor and punish the manager internally. However, this analysis is incomplete, since the shareholders face several problems, two of which are discussed here, namely the limitation in sanctioning options and collective action problems.

### 4.3.2.2 Limited sanction options

It appears reasonable to assume that \( K < F + z(t)t \), therefore it may be the case that even though \( p_s^* > p_g^* \), in the end \( p_s^*K \leq b \leq p_g^*q(F + z(t)t) \). The sanction available to the shareholders may be too limited to effectively deter, even with a high probability of detection.

### 4.3.2.3 Collective action problems

The shareholders are not a hierarchically organized body such as the government but have to coordinate the monitoring among each other. Since monitoring is costly, each individual shareholder would rather have the others monitoring and free ride on the benefits. In short, they face a collective action problem, with monitoring (M) being the collective good. The gravity of this problem is affected by the ownership structure.

Suppose that there are \( n \) shareholders with equal fractions of the shares, so that each enjoys \( v_i \), which is a fraction \( \kappa \) of the total benefit \( V \) of monitoring and total costs of monitoring are \( C(M) \), with \( C'(M) > 0 \) and \( C''(M) > 0 \), so that the Total Net Benefit (TNB) is
(14) \[ TNB = nM - C(M) = V - C(M) \]

The Individual Net Benefit (INB) equals

(15) \[ INB = \alpha nM - C(M) = \alpha V - C(M) = v_i - C(M) \]

A first possibility is that for each shareholder, \( v_i - C(M) < 0 \). This is more likely to be the case when ownership is more dispersed. In that case, the group is latent and ends up in a prisoners’ dilemma situation where no shareholder monitors and all bear the harm when the manager commits an offence. Game theoretically:

\[
\begin{array}{c|c|c}
& \text{Monitor} & \text{Defect} \\
\hline
\text{Monitor} & v_i - \frac{1}{n} C(M); & v_i; \\
& v_i - \frac{1}{n} C(M) & v_i - C(M) \\
\hline
\text{Defect} & v_i - C(M); & 0,0 \\
& v_i & \\
\end{array}
\]

The result will be that there is no monitoring, even though all would be better off if all would monitor.

If for each shareholder \( v_i - C(M) \geq 0 \), which could also happen when ownership is dispersed, the group is privileged and some level of monitoring can occur. However, the question
is then whether that level of monitoring will be optimal. The socially optimal level of monitoring would be where

$$\frac{\delta TNB}{\delta M} = 0$$

which is where

$$n = \frac{\delta C(M)}{\delta M}$$

However, individual shareholders will optimize

$$\frac{\delta TNB}{\delta M} = 0$$

which is where

$$\alpha n = \frac{\delta C(M)}{\delta M}$$

Graphically:

Thus, even when the individual benefit for the shareholders is sufficient to cover the monitoring costs, the level of monitoring is likely to be suboptimal.

When ownership is concentrated, the fractions $\alpha$ are not equal and it is likely that for the largest shareholder $v_i - C(M) \geq 0$. When there is a majority shareholder there is no collective action problem, since that shareholder can take action on his own. When the manager commits an offence to the detriment of all the shareholders, the majority shareholder can be expected to
intervene and punish the manager. In such cases the concentration of ownership eases private enforcement. However, a severe problem arises when the manager commits an offence that is in the interest of him and the largest shareholder but not in that of the minority shareholders. Rather than a collective action problem, this expropriation of minority shareholders results from the lack of decisive power of the shareholders. Monitoring of the shareholders then loses much of its value and this private enforcement mechanism is likely to fail.

4.3.2.4 Class actions and derivative suits

A possible solution to the problems of limited sanction options and collective action are class action or derivative suit rights granted by the government. Next to imposing internal sanctions $k$ in interval $[0, K]$ on the manager, now also monetary damages can be awarded to the shareholders by the court ($f_s$ in interval $[0, F]$). In addition, the right to derivative suits helps shareholders to coordinate litigation, while class action lowers the financial burden of litigation, lowering $c_s$ to $c_s'$.

A risk neutral, rational manager commits an offence if

$$b \geq p_s(f_s + k)$$

Suppose that shareholders sue the manager in all cases of detection of an offence. The shareholders now face the following optimization problem:

$$V = \int_{p_s(c_s f_s + k)}^{B}(V_0 - h)g(b)db - c_s'$$

Which is optimal when:

i) $k^* = K$, since imposition of the sanction is assumed costless.

ii) $f_s^* = F$, since increasing the level of damages is costless while monitoring is costly.
iii) $p^*_S$ is at the point where the marginal monitoring costs equal the reduction in the harm:

$$hg(b)db = c'_S(p^*_S)$$

Although the rights of class action and derivative suits are here depicted in a very simplified way, this is sufficient to show the main point with respect to deterrence, namely that these rights improve deterrence by increasing the chance that shareholders will initiate proceedings, due to both the better sanctioning options and the lower collective action problems. Khanna and Varottil 2012 show, in accordance with this model, that derivative actions are more effective in dispersed ownership structures, where collective action concerns are more central. For India derivative actions are therefore less likely to be widely used, which is indeed the case, even though this legal tool would be particularly valuable in India given its relatively weak institutional environment.
CHAPTER 5: PRELIMINARY EVIDENCE FROM INDIA

As discussed in Chapter 1, there is room for improvement in the field of enforcement for CGR in India. Chapter 2 made reference to the regulatory changes aimed at improving CGR and the inefficiencies that still remain. Bearing the conclusions from the economic theory of punishment in mind as discussed in Chapter 3 and 4, this last Chapter evaluates what has been achieved on a regulatory level to improve CGR effectiveness.

5.1 Companies Law Board

5.1.1 Sanctions in the Companies Act

The Companies Act 1956, enforced by the Companies Law Board (CLB), has been subject to a substantial amendment in 2002 and has been replaced all together in 2009 by the Companies Bill 2009. A comparison of these acts reveals that the maximum fines that can be imposed for violations have risen substantially over the years. Whereas the average maximum fine for all provisions under the Companies Act 1956 was around INR 8.000 (US$ 144), in 2002 it jumped to almost INR 30.000, to reach more than INR 823.000 in 2009, thus multiplying by more than 100 during that time (Table 1). The variability in the increase of various provisions is also quite large (Figures 1a-e). While some sanctions rose from INR 5.000-10.0000 to INR 100.000-500.000, there are extremes such as the audit report requirements, for which the fine multiplied by a thousand (INR 500 to INR 500.000). Although these increases appear to be extremely large, one must not forget that they have taken place over 50 years, during which time prices in India rose substantially too. Sarkar and Sarkar evaluate data on cases which demonstrates that the fines actually charged were still low in 2009, with an average of less than INR 3.000, including the ones for serious violations such as non-compliance with financial disclosure requirements or audit requirements.\footnote{Sarkar and Sarkar, p. 41.} Overall, although fines have been enhanced substantially on paper it remains to be seen whether courts will in fact charge these higher
maximum fines. From a deterrence perspective this is certainly advisable, especially bearing in mind that the increase in fines has been less substantial in real terms.

The average imprisonment term did not increase in the new Companies Bill 2009. To the contrary, it decreased slightly from almost 3 years on average to less than 2,5 years. No prison terms for less serious offences were introduced, so this cannot be the explanation for the lower average. From a deterrence perspective it is not necessarily negative that prison terms did not increase, given the high costs associated with imposing this sanction.

In light of the implications of punishing a company or its manager derived in the model, it is interesting to see whom the sanctions in the Companies Acts are directed at: at the company, an official, or both. The target of sanctions appears to have remained the same over time for each provision. Moreover, all sanctions are either targeted at an official or at an official and the company, the first category being the largest (60%, Figure 2). This is not necessarily the efficient choice according to the deterrence model, since for a number of offences the shareholders may be able to detect the violation at lower cost than the government, namely when they have an information advantage. However for some cases, such as impersonating a shareholder for personal gain, it would not make sense to sanction the company. Also it is very probable that investors would take the case to the authorities when detected. Looking at the Companies Acts, there still remain cases in which one could doubt the efficiency of the government spending resources on detection. Consider for example cases in which a director does not (yet) own the required qualification shares, or acts as a director for more than the maximum of 15 companies. From an efficiency perspective, it could be argued that such violations could be detected at lower costs by shareholder monitoring than by government investigation. Sanctions against the company, which are ultimately (at least partly) borne by the shareholders, could induce shareholders to incur such monitoring.

Other than the former Companies Acts, the Companies Bill 2009 specifies minimum sanctions in addition to maxima for some provisions, thereby giving clearer guidelines to courts
on what sanctions to impose.\textsuperscript{122} The lowest minimum sanction is Rs. 25,000, 2.5 times the highest maximum sentence that was specified in the original Companies Act. That demonstrates, just as the fact that repeated default will be sanctioned with double the specified fine under the new Companies Bill, that increasing deterrence to enhance enforcement has been taken up by the Indian government.

\textbf{5.1.2 Efficiency of the CLB}

Regarding the CLB’s efficiency, the CLB Annual Reports show that backlogs have decreased over the years. However, Sarkar and Sarkar distillate an estimation of the conviction rate from the data and conclude that this varies between 30\% and 66\% and that it was lower in the last five years than in the early 2000s.\textsuperscript{123} In light of the deterrence model a lower conviction rate implies that despite the higher sanctions, the overall deterrence may not have increased.

\textbf{5.2 Securities and Exchange Board of India}

\textbf{5.2.1 Sanctioning by Sebi}

For a long time Sebi had only very limited sanctions at its disposal to sanction non-compliance with the listing agreements. The most important sanction was delisting, about which Goyal points out that it was an ineffective deterrent because it was either extremely harsh compared to the damage or could be circumvented by using another participant as a front.\textsuperscript{124} Another sanction, suspension of trading, has been argued to hurt the investor community more than the management of the company.\textsuperscript{125} Once Sebi was granted the power to charge fines, the amounts were generally proportional to the damage that was inflicted and therefore still had little deterring effect.\textsuperscript{126} In 2004 Section 23E was added to the SCR Act, enhancing the sanctioning

\begin{footnotes}
\item[Sarkar and Sarkar 2012, p. 42.]
\item[Sarkar and Sarkar 2012, p. 41.]
\item[Goyal 2005, p. 25.]
\item[Gupta and Verma 2004, p. 18]
\item[Goyal 2005, p. 24.]
\end{footnotes}
options of Sebi substantially by specifying fines up to INR 25 crore. As Table 2 and Figure 3 show, Sebi has increasingly used its power to issue directions (Section 11B SEBI Act).

A list of cases concerning violations of the Collective Investment Schemes Regulations gives insight in the trend in fines and prison terms imposed by Sebi (Table 3). Under the Collective Investment Schemes (CISs), an entity collects money from investors for certain pre-specified purposes and later distributes the profits to the investors. When such CISs violate the CIS Regulations, for instance by raising money inconsistent with their statutory purpose, Sebi can impose various penalties. First, Sebi may initiate criminal prosecution if this is in the interest of the securities market and the investors (Section 24 SEBI Act). In addition, Sebi may require the violator not to collect money from investor or to launch any scheme, to dispose of the assets of the scheme and to refund all the money or assets to the investors. Sebi may also prohibit the violator from disposing of the properties of the scheme acquired in violation of the Regulations and, most severely, from operating in the capital market or from accessing the capital market for a specified period (Section 22-33 SEBI (Intermediaries) Regulations 2008).

The data in Table 2 concerns 78 prosecutions of violations of the CIS Regulations by Sebi that resulted in convictions by the ACMM Tis Hazari Court, Delhi. The cases were filed between 2001 and 2003 and were completed between 2004 and 2011. Although the data does not allow comparing between sanctions before and after the introduction of Clause 49 in 2004, it does show the trend in sanctioning since 2004. The average fine increased substantially over the years, multiplying by almost 14 times over a time span of 6 years (Table 4 and Figure 4). Clearly this is a positive development viewed from a deterrence perspective. Regarding imprisonment, this was not imposed at all until 2006 but in the years following the court started to carry out this sanction more frequently, reaching 8 times in 2010. The average prison time that was imposed

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127 The original list can be found on www.sebi.gov.in/cis/ProsecutionConviction.pdf. Last visited on 03/08/2012.
129 A few cases of the original list were left out for the reason of incomplete data.
shows more variance over time, but given the limited data (in total imprisonment was only ruled 17 times) no general conclusions should be derived from that observation (Table 4 and Figure 5). Again, it is interesting to examine whom the sanction is directed at. It appears that in 31% of these cases only officials within the company were sanctioned, while in the vast majority (the remaining 69%) also the company as an entity was fined (Figure 6). The picture is reversed now compared to that of the Companies Bill 2009. As discussed above sanctioning the company could be more efficient and this is particularly the case here. When a company raises money from the public in violation of the statutory purposes this should be easiest to find out by the investors by consulting the financial statements and reports. However, if it is the case that most of the investigations result from investor grievances, sanctions against the company might hamper investors’ incentives to take information on violations to Sebi.

5.2.2 Efficiency of Sebi

The CIS data also gives some insight in the efficiency of Sebi in terms of the time until completion of cases (Figure 7). Table 5 and Figure 8 show the number of years until completion of cases initiated between 1998 and 2005. Although quite some variance is observed over the years it appears that the time until completion has been decreasing since 2002. However, the fact that the list of completed cases does not include any cases with a filing date after 2005 might be a sign that recently cases have been taken longer again. In 2011 over 1 lakh investor complaints were pending with Sebi in connection to CISs.

Data from the SEBI Handbook of Statistics 2010 provides more general insight in the efficiency of Sebi in terms of disposal of cases. The past decade the regulator has taken up substantially more cases than before, whereas backlogs have decreased during the past years as well, showing that Sebi has become increasingly efficient (Figure 7). The number of cases taken up reached a peak in 2005-2006 and has been much lower since, which could be a sign of either a

\[^{130}\text{For this part also the cases with partly missing data are included.}\]

\[^{131}\text{SEBI Annual Report 2010-2011, Table 3.34, p. 122.}\]
decrease in the number of violations, which could mean that the higher sanctions have succeeded as a deterrent, or that Sebi has been less proactive, for instance due to a lack of capacity. Although Sebi has grown in staff substantially during the last 15 years (according to the Annual Reports from 111 employees in 1998 to 441 in 2005 and 538 in 2011), it cannot be derived from this data that the actual number of violations indeed decreased.

5.2.3 Persisting problems

Despite all the efforts to improve Sebi’s efficiency as well as effectiveness, Kaushik and Kamboj still describe Sebi as “slow, often arbitrary and opaque” in its investigation and appeal process. They state that the framework is in line with best practices of justice and fair play, but its implementation is problematic. They emphasize the problematic role consent orders play, allowing the accused to pay charges to be able to avoid having to undergo prosecution. Although the consent order scheme could save on litigation and regulatory costs, it also provides offenders a relatively easy way out of severe regulatory action, thereby reducing deterrence of the regulations.\textsuperscript{132} Another problem that remains is that unlisted companies, which form the vast majority of the companies in India, remain outside Sebi’s control.\textsuperscript{133} Transparency also still requires attention, both regarding the time limit to complete investigations, the independence and discretion of adjudicating officers and the amount of penalties to be charged.\textsuperscript{134}

Moreover, the regulatory arbitrage resulting from the overlap in powers of the MCA, Sebi and stock exchanges in the administration of company law needs attention.\textsuperscript{135} All companies are regulated by the MCA but listed companies are also bound by Sebi guidelines. The stock exchanges are entrusted with enforcement of the listing agreements but only Sebi can impose sanctions in case of violations. In addition, there are numerous tribunals and authorities besides the courts of law that are entrusted with the regulation of incorporation and winding up of

\textsuperscript{132} Kaushik and Kamboj 2011, p. 30.
\textsuperscript{133} Gupta and Verma 2004, p. 18
\textsuperscript{134} Goyal 2005, p. 27.
\textsuperscript{135} Goyal 2005, p. 27.
companies, such as the Registrar of Companies, Regional directors and Official Liquidators named in the Companies Act.\textsuperscript{136}

Lastly, in appeal cases Sebi is dependent on the Securities Appellate Tribunal (SAT), which dismisses most appeals.\textsuperscript{137} An insider trading decision from 2004 reveals the Court’s view on insider trading. In this case S. Ramesh and S. Bhaumik, secretary and executive director of a company, had bought shares of that company on behalf of their family members based on unpublished price sensitive information and tendered those at a higher price. Sebi initiated criminal proceedings, but the SAT overruled Sebi, arguing that “It is not clear as to why criminal proceedings have been commenced inspite of the fact that both Bhaumik and Ramesh admitted that they have made a mistake and are willing to pay back the ill-gotten gain. However, these are not within the domain of this Tribunal and it is for Sebi to catch hold of the bigger violators some of whom act to the detriment of economy of this country. […] Taking into account the sad financial situation of both the parties and their admission, it would be appropriate to consider reducing the penalty.” Although the case did indeed not involve very high stakes, insider trading should still not be taken up lightly. From a deterrence point of view it is not effective to punish insider traders with little over the damage they caused, since this is only deterring with a detection and conviction probability close to 1. Especially given the difficulties in proving insider trading cases it is very doubtful that Sebi’s sanctions will be deterring when in the end one can get away with paying the damages.

Overall, the data shows increases in the sanctions for both the CLB and Sebi, as well as improvements in efficiency, whereas for the conviction rate this is, partly due to data unavailability, less clear.

\textsuperscript{136} Gupta and Verma 2004, p. 9
\textsuperscript{137} SEBI Annual Report 2010-2011, p. 119-120.
**CONCLUSION**

This thesis aimed to find an answer to the question what role sanctions play in choosing the optimal enforcement mechanism for CGR in India. It was already clear from the existing literature that enforcement of CGR is central in developing countries. This is also the case in India, where various regulatory changes have taken place over the last decades, both regarding the content of the law and the capacity and powers of the regulators. Implementation is however still not optimal.

Public and private enforcement mechanisms appear to be complements rather than substitutes, since both have significant advantages as well as defects. Public enforcement allows for more severe sanctioning but faces problems when the state budget is very limited or when officials or politicians are not benevolent. Private mechanisms on the other hand often have an information advantage and private parties usually have an interest in detecting a violation. However, private enforcement suffers from free riding and collective action problems as well as a limited range of sanctioning options. Legal rights such as derivative suits and class actions can provide a solution to the latter two problems, but in India they have not really caught on yet. This is partly due to the fact that most companies in India are closely held family businesses. This means that minority shareholders do not so much suffer from collective action problems but from expropriation by majority shareholders. A policy recommendation could be for the Indian government to further explore the options to strengthen private parties in enforcement by trying to design legal tools that fit the business environment in India.

The economic model of deterrence, used to evaluate the enforcement mechanisms, suggests that fines should be raised to the maximum level affordable for the violator, in the case of CGR the company. It also proposes to consider sanctioning the company rather than the government whenever the company can detect the violation more easily. Perhaps there is room
here for more cooperation between the government and the industry, as already suggested in the CIPE Report (2002).

Data on the CLB and Sebi shows that the government, in accordance with the deterrence model, increased fines substantially during the last decade. Prison terms did not increase, but Sebi has started to use this sentence more often. Again the deterrence model would support this, although it is more reasonable to assume that this is for reasons other than the costs of executing the sanction, such as fairness considerations. The data also demonstrates that the regulators improved in efficiency over time, showing smaller backlogs and taking up more cases. Due to the lack of data on conviction rates it is not possible to fully apply the deterrence model to the data in order to find out whether the level of the penalties is effectively deterring. If this data was to become available this could be an interesting topic for further research. An indication of the findings such research might obtain, and simultaneously a positive note to finish this study on, is given by empirical studies performed by Black and Khanna 2007 and Dharmapala and Khanna 2008. Their findings demonstrate that the severe financial penalties introduced with the Clause 49 reforms in 2004 positively affected firm value in India with 10%. One can therefore conclude that despite the remaining inefficiencies, CGR enforcement in India has shown improvement.
## APPENDIX

### Table 1: Penalty provisions in the Companies Acts

<table>
<thead>
<tr>
<th>Clause</th>
<th>Section</th>
<th>Companies Act 1956</th>
<th>Companies (Amendment) Act 2002</th>
<th>Section</th>
<th>Companies Bill 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Target *</td>
<td>Fine (INR)</td>
<td>Prison term (yr)</td>
<td>Target *</td>
</tr>
<tr>
<td>Reference to expert in prospectus</td>
<td>59</td>
<td>P &amp; C</td>
<td>5.000</td>
<td>-</td>
<td>P &amp; C</td>
</tr>
<tr>
<td>Fraudulently inducing persons to invest money</td>
<td>68</td>
<td>P</td>
<td>10.000</td>
<td>5</td>
<td>P</td>
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<tr>
<td>Personation of a shareholder</td>
<td>116</td>
<td>P</td>
<td>N/s</td>
<td>3</td>
<td>P</td>
</tr>
<tr>
<td>General Meeting provisions</td>
<td>168</td>
<td>P &amp; C</td>
<td>5.000</td>
<td>-</td>
<td>P &amp; C</td>
</tr>
<tr>
<td>Issue of improper yearly statement</td>
<td>218</td>
<td>P &amp; C</td>
<td>500</td>
<td>-</td>
<td>P &amp; C</td>
</tr>
<tr>
<td>Appointing auditor</td>
<td>232</td>
<td>P &amp; C</td>
<td>500</td>
<td>-</td>
<td>P &amp; C</td>
</tr>
<tr>
<td>Audit report</td>
<td>233</td>
<td>Auditor +P</td>
<td>1.000</td>
<td>-</td>
<td>Auditor +P</td>
</tr>
<tr>
<td>Acting as a director without qualification shares</td>
<td>272</td>
<td>P</td>
<td>500/day</td>
<td>-</td>
<td>P</td>
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<tr>
<td>Acting as a director for more than 15 companies</td>
<td>279</td>
<td>P</td>
<td>5.000</td>
<td>-</td>
<td>P</td>
</tr>
<tr>
<td>Loan to company with same management in contravention of the provisions</td>
<td>371</td>
<td>P</td>
<td>5.000</td>
<td>0,5</td>
<td>P</td>
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<tr>
<td>Depositing of employees' securities</td>
<td>420</td>
<td>P</td>
<td>1.000</td>
<td>0,5</td>
<td>10.000</td>
</tr>
<tr>
<td>Receiver of a company</td>
<td>423</td>
<td>P &amp; C</td>
<td>200</td>
<td>-</td>
<td>2.000</td>
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<tr>
<td>Certain offences</td>
<td>424L</td>
<td>P &amp; C</td>
<td>10.000.00</td>
<td>3</td>
<td>P &amp; C</td>
</tr>
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<td>Falsification of P &amp; Cooks</td>
<td>539</td>
<td>P</td>
<td>N/s</td>
<td>7</td>
<td>P</td>
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<tr>
<td>Frauds P &amp; Cy officers</td>
<td>540</td>
<td>P</td>
<td>N/s</td>
<td>2</td>
<td>P</td>
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<tr>
<td>Production Company: use of 'Ltd'</td>
<td>581ZM</td>
<td>P</td>
<td>10000/day</td>
<td>-</td>
<td></td>
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<tr>
<td>Description</td>
<td>Code</td>
<td>P</td>
<td>5% of turnover</td>
<td>0,5</td>
<td>P</td>
</tr>
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<td>while not registered</td>
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<td>Production Company: Willfully fail to furnish information</td>
<td>581ZM</td>
<td>P</td>
<td>0,5</td>
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<tr>
<td>Production Company: Fail to hand over P &amp; Cooks or convene GM</td>
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<td>P</td>
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<td>5.000</td>
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<td>False evidence</td>
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<td>P</td>
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<td>Penalty if not defined (1956) / for contravention of any provision (2009)</td>
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<td>Wrongful withholding of property</td>
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<td>Personation for acquisition etc. of securities</td>
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<td>Acting as a director when not properly registered</td>
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<td>Duties of foreign companies</td>
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<td>Punishment if repeated default</td>
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Figures 1a-e: Comparison of sanctions in Companies Acts

Average maximum fines

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<tr>
<th>Fine (INR)</th>
<th>Com. Bill 2009, INR 500,000</th>
<th>Com. Act 1956, INR 20,000</th>
<th>Com. Act 1956, INR 10,000</th>
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Average maximum prison terms

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<th>Prison terms (Years)</th>
<th>Com. Bill 2009, 2,39</th>
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<td>Act 1956, 2,82</td>
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Sanctions on fraudently inducing persons to invest money

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<td>Com. Act 1956, INR 10,000</td>
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Sanction on violating the General Meeting requirements

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<td>Com. Act 1956, INR 5,000</td>
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Sanction on violating the audit report requirements

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<td>Com. Act 1956, INR 5,000</td>
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Section: 68/31

Section: 148/88

Section: 233/130
Figure 2: Target of sanctions in the Companies Acts

Target of the sanction
Companies Bill 2009

Table 2: Action taken by Sebi

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<td>Cancellation</td>
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<td>4</td>
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<td>11</td>
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<td>Suspension</td>
<td>39</td>
<td>16</td>
<td>30</td>
<td>4</td>
<td>8</td>
<td>42</td>
<td>43</td>
<td>42</td>
<td>36</td>
<td>52</td>
<td>44</td>
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<td>Warning issued</td>
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<td>17</td>
<td>28</td>
<td>9</td>
<td>36</td>
<td>62</td>
<td>22</td>
<td>53</td>
<td>71</td>
<td>27</td>
<td>48</td>
<td>179</td>
<td>37</td>
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<td>Prohibitive directions issued under Section 11B of SEBI Act</td>
<td>10</td>
<td>62</td>
<td>58</td>
<td>21</td>
<td>98</td>
<td>140</td>
<td>106</td>
<td>134</td>
<td>632</td>
<td>345</td>
<td>537</td>
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<td>Issues refunded/option given</td>
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<td>2</td>
<td>1</td>
<td>4</td>
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<td>2</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>6</td>
<td>156</td>
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<tr>
<td>Total</td>
<td>97</td>
<td>63</td>
<td>121</td>
<td>39</td>
<td>143</td>
<td>257</td>
<td>174</td>
<td>232</td>
<td>741</td>
<td>424</td>
<td>629</td>
<td>461</td>
<td>932</td>
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</table>
Figure 3: Actions taken by SEBI

Action taken by SEBI 1997-2010

Number of times an action was taken

Year

0 100 200 300 400 500 600 700 800


Suspension
Cancellation
Warning
Issues/option
Prohibitive sanctions 11B SEBI Act

SEBI Act
Table 3: Collective Investment Scheme cases filed by Sebi resulting in conviction

<table>
<thead>
<tr>
<th>SL No</th>
<th>Name of case/company</th>
<th>Amount of money that was mobilized</th>
<th>Fine (Rs)</th>
<th>Target</th>
<th>Prison term</th>
<th>Year filing</th>
<th>Year decision</th>
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<tr>
<td>4</td>
<td>M/s. Seth Dhanraj Agro (India) Ltd. and Others</td>
<td>INR 16,050,000</td>
<td>INR 25,000</td>
<td>P&amp;C</td>
<td>3 months cond.</td>
<td>2001</td>
<td>2004</td>
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<td>5</td>
<td>M/s. Sahyog Greenland Plantation Ltd. and Others</td>
<td>INR 70,000</td>
<td>INR 3,000</td>
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<td>1 month cond.</td>
<td>2004</td>
<td>2005</td>
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<td>6</td>
<td>M/s. Indus Spices and Herbs Ltd. and Others</td>
<td>INR 300,000</td>
<td>INR 6,000</td>
<td>P&amp;C</td>
<td>1 month cond.</td>
<td>2003</td>
<td>2006</td>
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<td>7</td>
<td>M/s. Coral Greenfields Ltd. and Others</td>
<td>INR 110,000</td>
<td>INR 5,000</td>
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<td>1 month cond.</td>
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<td>2006</td>
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<td>8</td>
<td>M/s. Sagaun Plantation Ltd. and Others</td>
<td>INR 300,000</td>
<td>INR 5,000</td>
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<td>1 month cond.</td>
<td>2004</td>
<td>2006</td>
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<td>M/s. Panacea Forest India Ltd. and Others</td>
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<td>M/s Reco Plantations Ltd. &amp; Others</td>
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<td>Year 1</td>
<td>Year 2</td>
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<td>2009</td>
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<td>2002</td>
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<td>M/s Purvanchal Plantations India Ltd and Others</td>
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<td>P</td>
<td>3 months cond.</td>
<td>2003</td>
<td>2009</td>
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<td>M/s Harbansram Tree Magnum Resorts(I) Ltd. And Others</td>
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<td>P</td>
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<td>INR 400,000</td>
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<td>M/s JSM Plantation &amp; Diary Farming Ltd. and Others</td>
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<td>P&amp;C</td>
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<td>INR 10,000</td>
<td>P&amp;C</td>
<td>3 months cond.</td>
<td>2003</td>
<td>2010</td>
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<td>86</td>
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<td>P&amp;C</td>
<td>4 months</td>
<td>2003</td>
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<td>87</td>
<td>M/s Fair deal Forests Ltd</td>
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<td>INR 50,000</td>
<td>P&amp;C</td>
<td>3 months cond.</td>
<td>2003</td>
<td>2011</td>
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<tr>
<td>88</td>
<td>M/s Sai Plantation &amp; Land Developments (I) Ltd. and Others</td>
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<td>P&amp;C</td>
<td>no</td>
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<td>M/s Anjali Orchard India Ltd. and Others</td>
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<td>INR 200,000</td>
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<td>no</td>
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<td>P&amp;C</td>
<td>4 months</td>
<td>2003</td>
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<td>91</td>
<td>M/s Abhiyan Agro Forest and Others</td>
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<td>INR 50,000</td>
<td>P</td>
<td>3 months cond.</td>
<td>2003</td>
<td>2011</td>
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<td>92</td>
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<td>INR 75,000</td>
<td>P&amp;C</td>
<td>no</td>
<td>2003</td>
<td>2011</td>
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* P: Person, P&C: Person and Company
### Table 4: Average sanctions imposed by SEBI in CIS cases over time

<table>
<thead>
<tr>
<th>Year</th>
<th>Average fines</th>
<th>No. prison sanctions</th>
<th>Average time (months)</th>
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<tr>
<td>2004</td>
<td>INR 25,000</td>
<td>0</td>
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<tr>
<td>2005</td>
<td>INR 3,000</td>
<td>0</td>
<td>0</td>
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<td>2006</td>
<td>INR 13,352</td>
<td>0</td>
<td>0</td>
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<td>2007</td>
<td>INR 8,208</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>2008</td>
<td>INR 31,222</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>2009</td>
<td>INR 79,500</td>
<td>3</td>
<td>12</td>
</tr>
<tr>
<td>2010</td>
<td>INR 341,818</td>
<td>8</td>
<td>7,125</td>
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<tr>
<td>1st quarter 2011</td>
<td>INR 75,000</td>
<td>2</td>
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</table>

### Figure 4: Average fines imposed by Sebi for CIS cases over time

![Average fine CIS cases](chart)

### Figure 5: Average prison terms CIS cases

![Average prison terms CIS cases](chart)
Figure 6: Target of sanctions Sebi

### Target of the sanction

- **31%**: Company not sanctioned
- **69%**: Company and (an) official(s) sanctioned

Figure 7: Average time until completion of CIS cases

### Average time until completion of CIS cases by SEBI

- **Average time until completion of cases initiated in that year**

Table 5: Number of cases taken up and completed by Sebi

<table>
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<tr>
<th></th>
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</thead>
<tbody>
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<td>Cases taken up</td>
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<td>3</td>
<td>2</td>
<td>60</td>
<td>122</td>
<td>53</td>
<td>55</td>
<td>56</td>
<td>68</td>
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<tr>
<td>Cases completed</td>
<td>2</td>
<td>3</td>
<td>2</td>
<td>18</td>
<td>55</td>
<td>46</td>
<td>60</td>
<td>57</td>
<td>46</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
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<td>125</td>
<td>121</td>
<td>130</td>
<td>159</td>
<td>120</td>
<td>25</td>
<td>76</td>
<td>71</td>
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<tr>
<td>Cases completed</td>
<td>29</td>
<td>106</td>
<td>152</td>
<td>179</td>
<td>81</td>
<td>102</td>
<td>169</td>
<td>83</td>
<td>74</td>
</tr>
</tbody>
</table>
Figure 8: Number of cases taken up and completed by Sebi

Investigations SEBI

Time (years)

Number of cases

Cases taken up for investigation
Cases completed
BIBLIOGRAPHY

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Analysis”, International Review of Law and Economics, 2, pp. 3-27.


OECD White Paper on Corporate Governance in Asia, 10 June 2003.


*Case law:*


*Laws and regulations:*

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Companies Act 1956

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Collective Investment Schemes Regulations 1999
SEBI (Intermediaries) Regulations 2008

Companies Bill 2009