



Subject: Professional Ethics

Chapter: Corporate Governance

Category: Notes

Meaning

The heart of corporate governance is transparency, disclosure, accountability and integrity. It is to be borne in mind that mere legislation does not ensure good governance. Good governance flows from ethical business practices even when there is no legislation.

Noble laureate Milton Friedman defined Corporate Governance as "the conduct of business in accordance with shareholders' desires, which generally is to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs. Governance is concerned with the intrinsic nature, purpose, integrity and identity of an organization with primary focus on the entity's relevance, continuity and fiduciary aspects. The root of the word Governance is from 'gubernate', which means to steer. Corporate governance would mean to steer an organization in the desired direction. The responsibility to steer lies with the board of directors/ governing board. Corporate or a Corporation is derived from Latin term "corpus" which means a "body". Governance means administering the processes and systems placed for satisfying stakeholder expectation. When combined Corporate Governance means a set of systems procedures, policies, practices, standards put in place by a corporate to ensure that relationship with various stakeholders is maintained in transparent and honest manner.

Definitions of Corporate Governance:

1. "Corporate Governance is concerned with the way corporate entities are governed, as distinct from the way business within those companies is managed. Corporate governance addresses the issues facing Board of Directors, such as the interaction with top management and relationships with the owners and others interested in the affairs of the company" Robert Ian (Bob) Tricker (who introduced the words corporate governance for the first time in his book in 1984)
2. "Corporate Governance is about promoting corporate fairness, transparency and accountability". James D. Wolfensohn (Ninth President World Bank)

OECD

Corporate governance structure specifies the distribution of rights and responsibilities among different participants in the company such as board, management, shareholders and other stakeholders; and spells out the rules and procedures for corporate decision-making. By doing this, it provides the structure through which the company's objectives are set along with the means of attaining these objectives as well as for monitoring performance.

Cadbury Committee, U.K

"(It is) the system by which companies are directed and controlled"

Corporate Governance is a system of structuring, operating and controlling a company with the following specific aims:—

- (i) Fulfilling long-term strategic goals of owners;

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- (ii) Taking care of the interests of employees;
- (iii) A consideration for the environment and local community;
- (iv) Maintaining excellent relations with customers and suppliers;
- (v) Proper compliance with all the applicable legal and regulatory requirements.

"Corporate governance deals with laws, procedures, practices and implicit rules that determine a company's ability to take informed managerial decisions vis-à-vis its claimants - in particular, its shareholders, creditors, customers, the State and employees. There is a global consensus about the objective of 'good' corporate governance: maximizing long-term shareholder value."

Confederation of Indian Industry (CII) - Desirable Corporate Governance Code (1998)

"Strong corporate governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure."

Report of Kumar Mangalam Birla Committee on Corporate Governance constituted by SEBI (1999)

"Corporate Governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company."

Report of N.R. Narayana Murthy Committee on Corporate Governance constituted by SEBI (2003)

"Corporate Governance is the application of best management practices, compliance of law in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders."

Need for CSR

Corporate social responsibility (CSR) promotes a vision of business accountability to a wide range of stakeholders, besides shareholders and investors. Key areas of concern are environmental protection and the wellbeing of employees, the community and civil society in general, both now and in the future.

The concept of CSR is underpinned by the idea that corporations can no longer act as isolated economic entities operating in detachment from broader society. Traditional views about competitiveness, survival and profitability are being swept away.

Some of the drivers pushing business towards CSR include:

1. The shrinking role of government

In the past, governments have relied on legislation and regulation to deliver social and environmental objectives in the business sector. Shrinking government resources, coupled with a distrust of regulations, has led to the exploration of voluntary and non-regulatory initiatives instead.

2. Demands for greater disclosure

There is a growing demand for corporate disclosure from stakeholders, including customers, suppliers, employees, communities, investors, and activist organizations.

3. Increased customer interest

There is evidence that the ethical conduct of companies exerts a growing influence on the purchasing decisions of customers. In a recent survey by Environics International, more than one in five consumers reported having either rewarded or punished companies based on their perceived social performance.

4. Growing investor pressure

Investors are changing the way they assess companies' performance, and are making decisions based on criteria that include ethical concerns. The Social Investment Forum reports that in the US in 1999, there was more than \$2 trillion worth of assets invested in portfolios that used screens linked to the environment and social responsibility. A separate survey by Environics International revealed that more than a quarter of share-owning Americans took into account ethical considerations when buying and selling stocks.

5. Competitive labor markets

Employees are increasingly looking beyond paychecks and benefits, and seeking out whose philosophies and operating practices match their own principles. In order to hire and retain skilled employees, companies are being forced to improve working conditions.

6. Supplier relations

As stakeholders are becoming increasingly interested in business affairs, many companies are taking steps to ensure that their partners conduct themselves in a socially responsible manner. Some are introducing codes of conduct for their suppliers, to ensure that other companies' policies or practices do not tarnish their reputation.

Some of the positive outcomes that can arise when businesses adopt a policy of social responsibility include:

1. Company benefits:

- Improved financial performance;
- Lower operating costs;
- Enhanced brand image and reputation;
- Increased sales and customer loyalty;
- Greater productivity and quality;
- More ability to attract and retain employees;
- Reduced regulatory oversight;
- Access to capital;
- Workforce diversity;
- Product safety and decreased liability.

2. Benefits to the community and the general public:

- Charitable contributions;
- Employee volunteer programmes;
- Corporate involvement in community education, employment and homelessness programmes ;
- Product safety and quality.

3. Environmental benefits:

- Greater material recyclability;
- Better product durability and functionality;
- Greater use of renewable resources;
- Integration of environmental management tools into business plans, including life-cycle assessment and costing, environmental management standards, and eco-labelling.

Nevertheless, many companies continue to overlook CSR in the supply chain - for example by importing and retailing timber that has been illegally harvested. While governments can impose embargos and penalties on offending companies, the organizations themselves can make a commitment to sustainability by being more discerning in their choice of suppliers.

The concept of corporate social responsibility is now firmly rooted on the global business agenda. But in order to move from theory to concrete action, many obstacles need to be overcome. A key

challenge facing business is the need for more reliable indicators of progress in the field of CSR, along with the dissemination of CSR strategies. Transparency and dialogue can help to make a business appear more trustworthy, and push up the standards of other organizations at the same time.

Need for Corporate Governance

Corporate Governance is integral to the existence of the company.

Corporate Governance is needed to create a corporate culture of Transparency, accountability and disclosure. It refers to compliance with all the moral & ethical values, legal framework and voluntarily adopted practices.

Corporate Performance: Improved governance structures and processes help ensure quality decision making, encourage effective succession planning for senior management and enhance the long-term prosperity of companies, independent of the type of company and its sources of finance. This can be linked with improved corporate performance- either in terms of share price or profitability.

Enhanced Investor Trust: Investors consider corporate Governance as important as financial performance when evaluating companies for investment. Investors who are provided with high levels of disclosure & transparency are likely to invest openly in those companies. The consulting firm McKinsey surveyed and determined that global institutional investors are prepared to pay a premium of up to 40 percent for shares in companies with superior corporate governance practices.

Better Access to Global Market: Good corporate governance systems attract investment from global investors, which subsequently leads to greater efficiencies in the financial sector.

Combating Corruption: Companies that are transparent, and have sound system that provide full disclosure of accounting and auditing procedures, allow transparency in all business transactions, provide environment where corruption will certainly fade out. Corporate Governance enables a corporation to compete more efficiently and prevent fraud and malpractices within the organization.

Easy Finance from Institutions: Several structural changes like increased role of financial intermediaries and institutional investors, size of the enterprises, investment choices available to investors, increased competition, and increased risk exposure have made monitoring the use of capital more complex thereby increasing the need of Good Corporate Governance. Evidence indicates that well-governed companies receive higher market valuations. The credit worthiness of a company can be trusted on the basis of corporate governance practiced in the company.

Enhancing Enterprise Valuation: Improved management accountability and operational transparency fulfill investors' expectations and confidence on management and corporations, and return, increase the value of corporations.

Reduced Risk of Corporate Crisis and Scandals: Effective Corporate Governance ensures efficient risk mitigation system in place. The transparent and accountable system that Corporate Governance makes the Board of a company aware of all the risks involved in particular strategy, thereby, placing various control systems to monitor the related issues.

Accountability: Investor relations' is essential part of good corporate governance. Investors have directly/ indirectly entrusted management of the company for the creating enhanced value for their investment. The company is hence obliged to make timely disclosures on regular basis to all its shareholders in order to maintain good investor's relation. Good Corporate Governance practices create the environment where Boards cannot ignore their accountability to these stakeholders.

Theoretical perspectives

Corporate Governance Theories

The following theories elucidate the basis of corporate governance:

- (a) Agency Theory
- (b) Shareholder Theory
- (c) Stake Holder Theory
- (d) Stewardship Theory

Agency Theory

According to this theory, managers act as 'Agents' of the corporation. The owners or directors set the central objectives of the corporation. Managers are responsible for carrying out these objectives in day-to-day work of the company. Corporate Governance is control of management through designing the structures and processes.

In agency theory, the owners are the principals. But principals may not have knowledge or skill for getting the objectives executed. The principal authorises the managers to act as 'Agents' and a contract between principal and agent is made. Under the contract of agency, the agent should act in good faith. He should protect the interest of the principal and should remain faithful to the goals.

In modern corporations, the shareholdings are widely spread. The management (the agent) directly or indirectly selected by the shareholders (the Principals), pursue the objectives set out by the shareholders. The main thrust of the Agency Theory is that the actions of the management differ from those required by the shareholders to maximize their return. The principals who are widely scattered may not be able to counter this in the absence of proper systems in place as regards

timely disclosures, monitoring and oversight. Corporate Governance puts in place such systems of oversight.

Stockholder/shareholder Theory

According to this theory, it is the corporation which is considered as the property of shareholders/stockholders. They can dispose of this property, as they like. They want to get maximum return from this property.

The owners seek a return on their investment and that is why they invest in a corporation.

But this narrow role has been expanded into overseeing the operations of the corporations and its managers to ensure that the corporation is in compliance with ethical and legal standards set by the government. So the directors are responsible for any damage or harm done to their property i.e., the corporation. The role of managers is to maximize the wealth of the shareholders. They, therefore should exercise due diligence, care and avoid conflict of interest and should not violate the confidence reposed in them. The agents must be faithful to shareholders.

Stakeholder Theory

According to this theory, the company is seen as an input-output model and all the interest groups which include creditors, employees, customers, suppliers, local-community and the government are to be considered. From their point of view, a corporation exists for them and not the shareholders alone.

The different stakeholders also have a self-interest. The interest of these different stakeholders is at times conflicting. The managers and the corporation are responsible to mediate between these different stakeholders interest. The stake holders have solidarity with each other. This theory assumes that stakeholders are capable and willing to negotiate and bargain with one another. This results in long term self-interest. The role of shareholders is reduced in the corporation. But they should also work to make their interest compatible with the other stake holders. This requires integrity and managers play an important role here.

They are faithful agents but of all stakeholders, not just stockholders.

Stewardship Theory

The word 'steward' means a person who manages another's property or estate. Here, the word is used in the sense of guardian in relation to a corporation, this theory is value based. The managers and employees are to safeguard the resources of corporation and its property and interest when the owner is absent. They are like a caretaker. They have to take utmost care of the corporation. They should not use the property for their selfish ends. This theory thus makes use of the social approach to human nature. The managers should manage the corporation as if it is their own corporation. They are not agents as such but occupy a position of stewards. The managers are motivated by the principal's objective and the behavior pattern is collective, pro-organizational and trustworthy. Thus, under this theory, first of all values as standards are identified and formulated. Second step is to

develop training programmes that help to achieve excellence. Thirdly, moral support is important to fill any gaps in values.

Corporate citizenship

The Securities and Exchange Board of India (SEBI) had set up a Committee under the Chairmanship of Kumar Mangalam Birla to promote and raise standards of corporate governance.

The Report of the committee was the first formal and comprehensive attempt to evolve a Code of Corporate Governance, in the context of prevailing conditions of governance in Indian companies, as well as the state of capital markets at that time. The recommendations of the Report, led to inclusion of Clause 49 in the Listing Agreement in the year 2000. These recommendations, aimed at improving the standards of Corporate Governance, are divided into mandatory and non-mandatory recommendations. The said recommendations have been made applicable to all listed companies with the paid-up capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company. The ultimate responsibility for putting the recommendations into practice lies directly with the Board of Directors and the management of the company.

A summary of the Report is reproduced hereunder:

The Board should have an optimum combination of Executive and Non Executive Directors with not less than 50 per cent of the Board consisting of non-executive directors.

In the case of Non-executive Chairman, at least one-third of the Board should consist of independent directors and in the case of an executive Chairman, at least half of the Board should consist of independent directors. The committee agreed on the following definition of independence:

"Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect their independence of judgment."

- Board meetings should be held at least four times in a year, with a maximum time gap of four months between any two meetings. A director should not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director.
- Financial Institutions should appoint nominee directors on a selective basis and nominee director should have the same responsibility, be subject to the same discipline and be accountable to the shareholders in the same manner as any other director of the company.
- Non-executive Chairman should be entitled to maintain Chairman's office at the expense of the company and also allowed reimbursement of expenses incurred in performance of his duties.
- Audit Committee - which a qualified and independent audit committee should be set up by the board of a company

- The audit committee should have minimum three members, all being non-executive directors, with the majority being independent, and with at least one director having the chairman of the committee should be an independent director;
- The chairman should be present at Annual General Meeting to answer shareholder queries;
- The audit committee should invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee but on occasions it may also meet without the presence of any executives of the company. Finance director and head of internal audit and when required, a representative of the external auditor should be present as invitees for the meetings of the audit committee;
- The Company Secretary should act as the secretary to the committee.
- Frequency of Meeting
- The audit committee should meet at least thrice a year. One meeting must be held before finalization of annual accounts and one necessarily every six months.
- The quorum should be either two members or one-third of the members of the audit committee, whichever is higher and there should be a minimum of two independent directors.

Powers of Audit Committee

- To investigate any activity within its terms of reference.
- To seek information from any employee.
- To obtain outside legal or other professional advice.
- To secure attendance of outsiders with relevant expertise, if it considers necessary.

Functions of the Audit Committee

- Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
- Recommending the appointment and removal of external auditor, fixation of audit fee and also approval for payment for any other services.
- Reviewing with management the annual financial statements before submission to the board, focusing primarily on:

Remuneration Committee

Remuneration Committee should comprise of at least three directors, all of whom should be non-executive directors, the chairman of committee being an independent director. All the members of the remuneration committee should be present at the meeting. These recommendations are non mandatory.

The board of directors should decide the remuneration of non-executive directors. The Corporate Governance section of the Annual Report should make disclosures about remuneration paid to Directors in all forms including salary, benefits, bonuses, stock options, pension and other fixed as well as performance linked incentives.

Shareholders/Investors' Grievance Committee of Directors - The Board should set up a Committee to specifically look into share holder issues including share transfers and redressal of shareholders' complaints.

- General Body Meetings - Details of last three AGMs should be furnished
- Disclosures - Details of non-compliance by the company including penalties and strictures imposed by the Stock Exchanges, SEBI or any statutory authority on any matter related to capital markets during the last three years must be disclosed to the shareholders.
- Means of communication - Half-yearly report to be sent to each household of shareholders, details of the mode of dissemination of quarterly results and presentations made to institutional investors to be disclosed and statement of Management Discussion and Analysis to be included in the report.
- General shareholder information - Various specified matters of interest to be included in the Annual Report.
- Auditor's Certificate on Corporate Governance - There should be an Auditor's certificate on corporate governance in the Annual Report as an annexure to the Director's Report.
- Companies should consolidated accounts in respect of all subsidiaries in which they hold 51 per cent or more of the capital.
- Information like quarterly results, presentation made by companies to analysts may be put on company's web-site or may be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.
- Shareholders to use the forum of General Body Meetings for ensuring that the company is being properly stewarded for maximizing the interests of the shareholders.
- A board committee under the chairmanship of a non-executive director should be formed to specifically look into the redressing of shareholder complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc.
- Half-yearly declaration of financial performance including summary of the significant events in last six-months, should be sent to each household of shareholders.

The institutional shareholders should:

Take active interest in the composition of the Board of Directors. Be vigilant Maintain regular and systematic contact at senior level for exchange of views on management, strategy, performance and the quality of management. Ensure that voting intentions are translated into practice. Evaluate the corporate governance performance of the company.

TYPES OF BOARD

Unitary Board

The unitary board, remains in full control of every aspect of the company's activities. It initiates action and it is responsible for ensuring that the action which it has initiated is carried out. All the directors, whether executive or outside, share same aims and responsibilities and are on the same platform.

Two-tier Boards

The alternative board model to unitary board is the two-tier board, which was developed in its present form in Germany.

A two-tier board fulfils the same basic functions as a unitary board, but it does so through a clear separation between the tasks of monitoring and that of management. The supervisory board (Aufsichtsrat) oversees the direction of the business and the management board (Vorstand) is responsible for the running of the company. The supervisory board controls the management board through appointing its members and through its statutory right to have the final say in major decisions affecting the company. The structure rigorously separates the control function from the management function and members of the one board cannot be members of the other. This separation is enshrined in law and the legal responsibilities of the two sets of board members are different.

The supervisory board system was introduced to strengthen the control of shareholders, particularly the banks, over the companies in which they had invested. Shareholdings are more concentrated in Germany and most quoted companies have at least one major shareholder, often a family or another company. Banks play an important part in governance as investors, lenders and through the votes of individual shareholders for which they hold proxies. They are, therefore, well represented on supervisory boards.

STRATEGIES FOR CORPORATE SOCIAL RESPONSIBILITY:

Recommendations of Report of Committee on The Financial Aspects on Corporate Governance, 1992 under the chairmanship of Sir Adrian Cadbury set up by the London Stock Exchange, the Financial Reporting Council and accounting professions to focus on the control and reporting functions of boards, and on the role of auditors.

Role of Board of Directors

The Report introduced "The Code of Best Practice" directing the boards of directors of all listed companies registered in the UK, and also encouraging as many other companies as possible aiming at compliance with the requirements. All listed companies should make a statement about their compliance with the Code in their report and accounts as well as give reasons for any areas of non-compliance. It is divided into four sections:

1. Board of Directors:

- a) The board should meet regularly, retain full and effective control over the company and monitor the executive management.
- b) There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.

- c) Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board, with a recognized senior member, that is, there should be a lead independent director.
- d) All directors should have access to the advice and services of the company secretary, who is responsible to the Board for ensuring that board procedures are followed and that applicable rules and regulations are complied with.

2. Non-Executive Directors:

- a) The non-executive directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.
- b) The majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholding.

3. Executive Directors:

There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest-paid directors, including pension contributions and stock options, in the company's annual report, including separate figures for salary and performance-related pay.

4. Financial Reporting and Controls:

It is the duty of the board to present a balanced and understandable assessment of their company's position, in reporting of financial statements, for providing true and fair picture of financial reporting. The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary. The board should ensure that an objective and professional relationship is maintained with the auditors.

Role of Auditors

- a) The Report recommended for the constitution of Audit Committee with a minimum of three non executive members majority of whom shall be independent directors.
- b) The Report recommended that a professional and objective relationship between the board of directors and auditors should be maintained, so as to provide to all a true and fair view of company's financial statements. Auditors' role is to design audit in such a manner so that it provide a reasonable assurance that the financial statements are free of material misstatements.
- c) The Report recommended for rotation of audit partners to prevent the relationships between the management and the auditors becoming too comfortable.

Rights & Responsibilities of Shareholders

The Report emphasizes on the need for fair and accurate reporting of a company's progress to its shareholders. The Report placed importance on the role of institutional investors/ shareholders and encouraged them to make greater use of their voting rights and take positive interest in the board functioning. Both shareholders and boards of directors should consider how the effectiveness of

general meetings could be increased as well as how to strengthen the accountability of boards of directors to shareholders.

Developments in India:

The initiatives taken by Government in 1991, aimed at economic liberalization and globalization of the domestic economy, led India to initiate reform process in order to suitably respond to the developments taking place world over. On account of the interest generated by Cadbury Committee Report, the Confederation of Indian Industry (CII), the Associated Chambers of Commerce and Industry (ASSOCHAM) and, the Securities and Exchange Board of India (SEBI) constituted Committees to recommend initiatives in Corporate Governance.

Confederation of Indian Industry (CII) - Desirable Corporate Governance:

A Code CII took a special initiative on Corporate Governance, the first institution initiative in Indian Industry. The objective was to develop and promote a code for Corporate Governance to be adopted and followed by Indian companies, whether in the Private Sector, the Public Sector, Banks or Financial Institutions, all of which are corporate entities. The final draft of the said Code was widely circulated in 1997. In April 1998, the Code was released. It was called Desirable Corporate Governance: A Code. A brief summary of the Desirable Corporate Governance Code is reproduced hereunder:

Recommendation I

The full board should meet a minimum of six times a year, preferably at an interval of two months, and each meeting should have agenda items that require at least half a day's discussion.

Recommendation II

Any listed company with a turnover of Rs.100 crores and above should have professionally competent, independent, non-executive directors, who should constitute:

- At least 30 per cent of the board if the Chairman of the company is a non-executive director,
- At least 50 per cent of the board if the Chairman and Managing Director is the same person.

Recommendation III

No single person should hold directorships in more than 10 listed companies. This ceiling excludes directorships in subsidiaries (where the group has over 50 per cent equity stake) or associate companies (where the group has over 25 per cent but no more than 50 per cent equity stake).

Recommendation IV

For non-executive directors to play a material role in corporate decision making and maximizing long term shareholder value, they need to:

- become active participants in boards, not passive advisors;
- have clearly defined responsibilities within the board such as the Audit Committee; and

- know how to read a balance sheet, profit and loss account, cash flow statements and financial ratios and have some knowledge of various company laws.

This, of course, excludes those who are invited to join boards as experts in other fields such as science and technology.

Recommendation V

To secure better effort from non-executive directors companies should:

- Pay a commission over and above the sitting fees for the use of the professional inputs. The present commission of 1% of net profits (if the company has a managing director), or 3% (if there is no managing director) is sufficient.
- Consider offering stock options, so as to relate rewards to performance. Commissions are rewards on current profits. Stock options are rewards contingent upon future appreciation of corporate value. An appropriate mix of the two can align a non-executive director towards keeping an eye on short- term profits as well as longer term shareholder value.

Recommendation VI

While re-appointing members of the board, companies should give the attendance record of the concerned directors. If a director has not been present (absent with or without leave) for 50 per cent or more meetings, then this should be explicitly stated in the resolution that is put to vote.

Recommendation VII

Key information that must be reported to, and placed before, the board must contain:

- Annual operating plans and budgets, together with up-dated long term plans.
- Capital budgets, manpower and overhead budgets.
- Quarterly results for the company as a whole and its operating divisions or business segments.
- Internal audit reports, including cases of theft and dishonesty of a material nature.
- Show cause, demand and prosecution notices received from revenue authorities which are considered to be materially important (Material nature if any exposure that exceeds 1 per cent of the company's net worth).
- Default in payment of interest or non-payment of the principal on any public deposit and/or to any secured creditor or financial institution.
- Fatal or serious accidents, dangerous occurrences, and any effluent or pollution problems.
- Defaults such as non-payment of inter-corporate deposits by or to the company, or materially substantial non-payment for goods sold by the company.
- Any issue which involves possible public or product liability claims of a substantial nature, including any judgment or order which may have either passed strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company.
- Details of any joint venture or collaboration agreement.
- Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.

- Recruitment and remuneration of senior officers just below the board level, including appointment or removal of the Chief Financial Officer and the Company Secretary.
- Labour problems and their proposed solutions.
- Quarterly details of foreign exchange exposure and the steps taken by management to limit the risks of adverse exchange rate movement, if material.

Recommendation VIII

- Listed companies with either a turnover of over Rs.100 crores or a paid-up capital of Rs. 20crores should set up Audit Committees within two years.
- Composition: at least three members, all drawn from a company's non-executive directors, who should have adequate knowledge of finance, accounts and basic elements of company law.
- To be effective, the Audit Committees should have clearly defined Terms of Reference and its members must be willing to spend more time on the company's work vis-à-vis other nonexecutive directors.
- Audit Committees should assist the board in fulfilling its functions relating to corporate accounting and reporting practices, financial and accounting controls, and financial statements and proposals that accompany the public issue of any security - and thus provide effective supervision of the financial reporting process.
- Audit Committees should periodically interact with the statutory auditors and the internal auditors to ascertain the quality and veracity of the company's accounts as well as the capability of the auditors themselves.
- For Audit Committees to discharge their fiduciary responsibilities with due diligence, it must be incumbent upon management to ensure that members of the committee have full access to financial data of the company, its subsidiary and associated companies, including data on contingent liabilities, debt exposure, current liabilities, loans and investments.
- By the fiscal year 1998-99, listed companies satisfying criterion (1) should have in place a strong internal audit department, or an external auditor to do internal audits.

Recommendation IX

Under "Additional Shareholder's Information", listed companies should give data on:

- High and low monthly averages of share prices in a major Stock Exchange where the company is listed for the reporting year.
- Statement on value added, which is total income minus the cost of all inputs and administrative expenses.
- Greater detail on business segments, up to 10% of turnover, giving share in sales revenue, review of operations, analysis of markets and future prospects.

Recommendation X

Consolidation of Group Accounts should be optional and subject to:

- The FIs allowing companies to leverage on the basis of the group's assets, and
- The Income-tax Department using the group concept in assessing corporate income-tax.

- If a company chooses to voluntarily consolidate, it should not be necessary to annex the accounts of its subsidiary companies under Section 212 of the Companies Act.
- However, if a company consolidates, then the definition of "group" should include the parent company and its subsidiaries (where the reporting company owns over 50% of voting stake).

Recommendation XI

Major Indian stock exchanges should gradually insist upon a compliance certificate, signed by the CEO and the CFO, which clearly states that:

- The management is responsible for the preparation, integrity and fair presentation of the financial statements and other information in the Annual Report, and which also suggest that the company will continue in business in the course of the following year.
- The accounting policies and principles conform to standard practice, and where they do not, full disclosure has been made of any material departures.
- The board has overseen the company's system of internal accounting and administrative controls systems either through its Audit Committee (for companies with a turnover of Rs.100 crores or paid-up capital of Rs. 20 crores) or directly.

Recommendation XII

For all companies with paid-up capital of Rs. 20 crores or more, the quality and quantity of disclosure that accompanies a GDR issue should be the norm for any domestic issue.

Recommendation XIII

The Government must allow far greater funding to the corporate sector against the security of shares and other paper.

Recommendation XIV

It would be desirable for FIs as pure creditors to re-write their covenants to eliminate having nominee directors except:

- In the event of serious and systematic debt default; and
- In case of the debtor company not providing six-monthly or quarterly operational data to the concerned FI(s).

Recommendation XV

- If any company goes to more than one credit rating agency, then it must divulge in the prospectus and issue document the rating of all the agencies that did such an exercise.
- It is not enough to state the ratings. These must be given in a tabular format that shows where the company stands relative to higher and lower ranking. It makes considerable difference to an investor to know whether the rating agency or agencies placed the company in the top slots or in the middle or in the bottom.

- It is essential that we look at the quantity and quality of disclosures that accompany the issue of company bonds, debentures, and fixed deposits in the USA and Britain - if only to learn what more can be done to inspire confidence and create an environment of transparency.
- Companies which are making foreign debt issues cannot have two sets of disclosure norms: an exhaustive one for the foreigners, and a relatively minuscule one for Indian investors.

Recommendation XVI

Companies that default on fixed deposits should not be permitted to:

- accept further deposits and make inter-corporate loans or investments until the default is made good; and
- declare dividends until the default is made good.

Gist of Coverage of CII Desirable Corporate Governance: A Code

Recommendation I - Frequency of Board meetings

Recommendation II - Board Composition

Recommendation III - No. of directorships

Recommendation IV - Role, Responsibilities, Qualifications of Non-executive Directors

Recommendation V - Remuneration of non-executive directors

Recommendation VI - Disclosure of attendance record for reappointment

Recommendation VII - Key information to the Board

Recommendation VIII - Audit Committee

Recommendation IX - Disclosure on shareholder information

Recommendation X - Consolidated Accounts

Recommendation XI - Compliance certificate

Recommendation XII - Disclosure relating to Global Depository Receipts (GDR)

Recommendation XIII - Funding

Recommendation XIV - Nominee Director

Recommendation XV - Disclosure of Ratings

Recommendation XVI - Default on fixed deposits by company

Challenges and Implementation

Company being an artificial person it requires certain natural persons to represent the company at various fronts. The position of directors in their relationship to the company is not only as the agents, but also trustees of the company

Executive Director: The term executive director is usually used to describe a person who is both a member of the board and who also has day to day responsibilities in respect of the affairs of the company. Executive directors perform operational and strategic business functions such as:

- Managing people

- Looking after assets
- Hiring and firing
- Entering into contracts

Executive directors are usually employed by the company and paid a salary, so are protected by employment law.

Examples of executive directors are production director, finance director or managing director or whole time director.

Section 2(26) of the Companies Act, 1956 defines Managing Director as - "managing director" means a director who, by virtue of an agreement with the company or of a resolution passed by the company in general meeting or by its Board of directors or, by virtue of its memorandum or articles of association, is entrusted with [substantial powers of management] which would not otherwise be exercisable by him, and includes a director occupying the position of a managing director, by whatever name called.

Provided that the power to do administrative acts of a routine nature when so authorised by the Board such as the power to affix the common seal of the company to any document or to draw and endorse any cheque on the account of the company in any bank or to draw and endorse any negotiable instrument or to sign any certificate of share or to direct registration of transfer of any share, shall not be deemed to be included within substantial powers of management:

Provided further that a managing director of a company shall exercise his powers subject to the Superintendence, control and direction of its Board of directors;

EVOLUTION OF CORPORATE GOVERNANCE

Corporate Governance Developments in USA

1977 The Foreign Corrupt Practices Act

1979 US Securities Exchange Commission

1985 Treadway commission

1992 COSO issued Internal Control

2002 Sarbanes - Oxley Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 Provides for specific provisions regarding establishment, maintenance and review of systems of internal control. Emphasized the need of putting in place a proper control environment, desirability of constituting independent boards and its committees and objective internal audit function. As a consequence, the Committee of Sponsoring Organizations (COSO) took birth.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued Internal Control - Integrated Framework. It is a framework "to help businesses and other entities assess and enhance their internal control systems".

The Act made fundamental changes in virtually every aspect of corporate governance in general and auditor independence, conflict of interests, corporate responsibility, enhanced financial disclosures and severe penalties for willful default by managers and auditors, in particular.

Vote on Executive Pay and Golden Parachutes: Gives shareholders a say on pay with the right to a non-binding (advisory) vote on executive pay and golden parachutes (acquisitions). This gives shareholders a powerful opportunity to hold accountable executives of the companies they own, and a chance to disapprove where they see the kind of misguided incentive schemes that threatened individual companies and in turn the broader economy.

Case Studies with lessons learned

Securities Exchange Commission, USA, in a recent case has begun a new era of scrutinizing liability of independent directors by bringing an action against independent director. In SEC v. Raval, Civil Action No. 8:10-cv-00101 (D.Neb. filed Mar.15,2010) it was alleged that Vasant Raval, former Chairman of the Audit Committee of Info Group Inc.(now Info USA, Inc.) had failed to sufficiently investigate certain "red flags" surrounding the company's former CEO and Chairman of the Board,

Vinod Gupta. The SEC's complaint alleged that Vasant Raval 70, resident of Nebraska, served on the board of directors for Info Group in various positions from 2003 to 2008, including a stint as Chairman of the Audit Committee. During this period, Raval allegedly turned a blind eye to allegations that Vinod Gupta directed the company to improperly pay himself \$9.5 million that he then spent on corporate jets, service for his yacht, life insurance premiums, and payment of personal credit cards. In addition, the complaint alleged that Gupta directed the company to enter into related party transactions totaling approximately \$9.3 million with entities that he controlled or with whom he was affiliated viz. Annapurna Corporation (now Everest Corporation), Aspen Leasing Services, LLC ("Aspen Leasing"). These related party transactions were not disclosed in the company's public filings.

The Commission also alleged that Raval failed to respond appropriately to various red flags concerning Gupta's expenses and Info's related party transactions with Gupta's entities. According to the complaint, Raval failed to take appropriate action regarding the concerns expressed to him by two internal auditors of Infogroup Inc., that Gupta was submitting requests for reimbursement of personal expenses. In a board meeting, Raval was tasked with investigating the propriety of the transactions. Rather than seeking assistance from outside counsel or rigorously scrutinizing the transactions, Raval began his "in depth investigation" and presented a report to the company's board merely in 12 days. The "Raval Report" however, omitted critical facts.

Despite numerous prompts by internal auditor, Raval failed to undertake a thorough investigation. As a result, the company allegedly failed to disclose related party transactions and materially understated Gupta's compensation. Although Raval did not make any pecuniary benefits, he failed to discharge his duties and take meaningful action to further investigate Gupta's misconduct and misappropriation of company funds.

The SEC charged Raval for failing in his 'affirmative responsibilities' and thus violating the antifraud, proxy, and reporting provisions of the US Exchange Act. To settle his case, Raval consented to the entry of a permanent injunction prohibiting future violations of the related provisions of the federal securities laws, a \$50,000 civil penalty, and a five-year ban from serving as an officer or director of a company.

Indian scenario:

In Bhopal Gas Tragedy verdict, the Bhopal Trial Court on 7th June 2010 has held Keshub Mahindra reputed industrialist, the then non executive chairman of Union Carbide India limited(UCIL), guilty

and sentenced him to two years of imprisonment along with seven others accused. He was charged of attending only a few meetings in a year and took only macro view of the company's developments.

A non-vigilant act of non- executive chairman, accounted for death of thousands. "Ignorance" of the system by the director of the company is unacceptable. Role of non executive director in this case is questionable. Later he was granted bail.

Lead Independent Director

Internationally, it is considered a good practice to designate an independent director as a lead independent director or senior independent director. He coordinates the activities of other nonemployee directors and advises chairman on issues ranging from the schedule of board meetings to recommending retention of advisors and consultants to the management.

- Acts as the principal liaison between the independent directors of the Board and the
- Chairman of the Board;
- Develops the agenda for and preside at executive sessions of the Board's independent directors;
- Advises the Chairman of the Board as to an appropriate schedule for Board meetings, seeking to ensure that the independent directors can perform their duties responsibly while not interfering with the flow of Company operations;
- Approves with the Chairman of the Board the agenda for Board and Board Committee meetings and the need for special meetings of the Board;
- Advises the Chairman of the Board as to the quality, quantity and timeliness of the information submitted by the Company's management that is necessary or appropriate for the independent directors to effectively and responsibly perform their duties;
- Recommends to the Board the retention of advisors and consultants who report directly to the Board;
- Interviews, along with the chair of the Nominating and Corporate Governance Committee, all Board candidates, and make recommendations to the Nominating and Corporate Governance Committee;
- Assists the Board and Company officers in better ensuring compliance with and implementation of the Governance Guidelines;
- Serves as Chairman of the Board when the Chairman is not present; and
- Serves as a liaison for consultation and communication with shareholders.

California Public Employees' Retirement System (CalPERS) provides that where the Chairman of the board is not an independent director, and the role of Chairman and CEO is not separate, the board should name a director as lead independent director who should have approval over information flow to the board, meeting agendas, and meeting schedules to ensure a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors. Other roles of the lead independent director should include chairing meetings of nonmanagement directors and of independent directors, presiding over board meetings in the absence of the chair, serving as the principle liaison between the independent directors and the chair, and leading the board/director evaluation process. Given these additional responsibilities, the lead independent director is expected to devote a greater amount of time to board service than the other directors.

Chairman

The responsibility for ensuring that boards provide the leadership which is expected of them is that of their chairman. Chairmen, however, have no legal position; they are whoever the board elects to take the chair at a particular meeting. Boards are not bound to continue with the same chairman for successive meetings. In law, all directors have broadly equal responsibilities and chairmen are no more equal than any other board member. Chairmen are an administrative convenience and a means of ensuring that board meetings are properly conducted.

Thus from a statutory point of view there is no necessity for a board to have a continuing chairman. The chairmanship could, for example, rotate among board members. Although board chairmen have no statutory position, the choice of who is to fill that post is crucial to board effectiveness. If the chairman is not up to the task, it is improbable that the meeting will achieve anything but frustration and waste of that most precious of resources—time. Continuity and competence of Chairmanship is vital to the contribution which boards make to their companies. The leaders which boards give to their companies, stems from the leadership which chairmen give to their boards. The Chairman's primary responsibility is for leading the Board

and ensuring its effectiveness.

The role of the Chairman includes:

- Setting the Board agenda, ensuring that Directors receive accurate, timely and clear information to
- Enable them to take sound decisions, ensuring that sufficient time is allowed for complex or contentious issues, and
- Encouraging active engagement by all members of the Board;
- Taking the lead in providing a comprehensive, formal and tailored induction programme for new Directors, and in addressing the development needs of individual Directors to ensure that they have the skills and knowledge to fulfill their role on the Board and on Board Committees;
- Evaluating annually the performance of each Board member in his/her role as a Director, and
- Ensuring that the performance of the Board as a whole and its Committees is evaluated annually.
- Holding meetings with the non executive Directors without the executives being present;
- Ensuring effective communication with shareholders and in particular that the company maintains
- Contact with its principal shareholders on matters relating to strategy, governance and Directors' remuneration.
- Ensuring that the views of shareholders are communicated to the Board as a whole.

As per the Institute of Directors (IOD) (UK), the following are the responsibilities of a chairman

- The chairman's primary role is to ensure that the board is effective in its tasks of setting and implementing the company's direction and strategy.

The chairman is appointed by the board and the position may be full- time or part time. The role is often combined with that of managing director or chief executive in smaller companies. However, the joint role is considered to be less appropriate for public companies listed. The main features of the role of chairman are as follows:

- Being chairman of the board, he/she is expected to act as the company's leading representative which will involve the presentation of the company's aims and policies to the outside world;
- To take the chair at general meetings and at board meetings. With regard to the latter this will involve:
- The determination of the order of the agenda;
- Ensuring that the board receives proper information;
- Keeping track of the contribution of individual directors and ensuring that they are all involved in
- Discussions and decision making. At all meetings the chairman should direct discussions towards the emergence of a consensus view and sum up discussions so that everyone understands what has been agreed;
- To take a leading role in determining the composition and structure of the board. This will involve
- Regular reviews of the overall size of the board, the balance between executive and non-executive directors and the balance of age, experience and personality of the directors.

CHIEF EXECUTIVE OFFICER (CEO)

The Board appoints the CEO based on the criterion of his capability and competence to manage the company effectively. His main responsibilities include developing and implementing high- level strategies, making major corporate decisions, managing the overall operations and resources of a company, and acting as the main point of communication between the board of directors and the corporate operations.

He is involved with every aspect of the company's performance. The CEO is supported and advised by a skilled board and CEO is ultimately accountable to the board for his actions. The most important skill of a CEO is to think strategically. His key role is leading the long term strategy and its implementation, it further includes:

Developing implementation plan of action to meet the competition and keeping in mind the long

- term existence of the company
- Adequate control systems
- Monitoring the operating and financial outcomes against the set plan
- Remedial action
- Keeping the Board informed

CEO should be able to, by the virtue of his ability, expertise; resources and authority keep the company prepared to avail the benefit of any change whether external or internal.

Separation of role of Chairman and Chief Executive Officer

It is perceived that separating the roles of chairman and chief executive officer (CEO) increases the effectiveness of a company's board.

It is the board's and chairman's job to monitor and evaluate a company's performance. A CEO, on the other hand, represents the management team. If the two roles are performed by the same person, then it's an individual evaluating himself. When the roles are separate, a CEO is far more accountable.

To prevent unfettered decision making power with a single individual, Corporate Governance Voluntary Guidelines, 2009 provide for the separation of the roles of the chairman of the Board and that of the Managing Director/CEO.

ICSI Recommendations to strengthen Corporate Governance suggests that there should be clear demarcation of the roles and responsibilities of the chairman of the board and that of the Managing Director/CEO. The roles of Chairman and CEO should be separated to promote balance of power.

The chairman is responsible for leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda. The chairman is also responsible for ensuring that the directors receive accurate, timely and clear information. The chairman should ensure effective communication with shareholders. The chairman should also facilitate the effective contribution of non-executive directors in particular and ensure constructive relations between executive and non-executive directors.

A clear demarcation of the roles and responsibilities of the Chairman of the Board and that of the Managing Director/CEO promotes balance of power. The benefits of separation of roles of Chairman and CEO can be:

1. Director Communication: A separate chairman provides a more effective channel for the board to express its views on management
2. Guidance: a separate chairman can provide the CEO with guidance and feedback on his/her performance
3. Shareholders' interest: The chairman can focus on shareholder interests, while the CEO manages the company
4. Governance: a separate chairman allows the board to more effectively fulfill its regulatory requirements
5. Long-Term Outlook: separating the position allows the chairman to focus on the long-term strategy while the CEO focuses on short-term profitability
6. Succession Planning: a separate chairman can more effectively concentrate on corporate succession plans.

COMPANY SECRETARY

CORPORATE GOVERNANCE

NOTES

Section 2(45) of the Companies Act, 1956 defines the term 'secretary' to mean a company secretary within the meaning of Section 2(1)(c) of the Company Secretaries Act, 1980 and includes any other individual possessing the prescribed qualifications and appointed to perform the duties which may be performed by a secretary under the Companies Act, 1956 and any other ministerial or administrative duties. Every company in India having a paid-up capital of not less than rupees five crore (limit increased from rupees two crore to five crore in 2009) shall be requiring to appoint a whole-time company secretary. Under Section 5 of the Companies Act, the company secretary has also been included in the category of the officer of the company and shall be considered to be in default in complying with any provisions of the Companies Act, 1956.

Role of Capital Market

Capital market plays an extremely important role in promoting and sustaining the growth of an economy. It is an important and efficient conduit to channel and mobilize funds to enterprises, and provide an effective source of investment in the economy. It plays a critical role in mobilizing savings for investment in productive assets, with a view to enhancing a country's long-term growth prospects. It thus acts as a major catalyst in transforming the economy into a more efficient, innovative and competitive marketplace within the global arena.

In addition to resource allocation, capital markets also provide a medium for risk management by allowing diversification of risk in the economy. A well-functioning capital market also tends to improve information quality as it plays a major role in encouraging the adoption of stronger corporate governance principles, thus supporting a trading environment, which is founded on integrity.

Capital market has played a crucial role in supporting periods of technological progress and economic development throughout history. Among other things, liquid markets make it possible to obtain financing for capital-intensive projects with long gestation periods. This certainly held true during the industrial revolution in the 18th century and continues to apply even as we have moved towards the so-called "New Economy".

The existence of deep and broad capital market is absolutely crucial and critical in spurring the growth of our country. An essential imperative for India has been to develop its capital market to provide alternative sources of funding for companies and in doing so, achieve more effective mobilization of investors' savings. Capital market also provides a valuable source of external finance.

For a long time, the Indian market was considered too small to warrant much attention. However, this view has changed rapidly as vast amounts of international investment have poured into our

markets over the last decade. The Indian market is no longer viewed as a static universe but as a constantly evolving market providing attractive opportunities to the global investing community.

Corporate Governance Rating

A corporate governance rating refers to the status of a company with respect to the adoption of corporate governance practices. This rating is the final opinion regarding the important a corporation attached to corporate governance by looking at the information they provide to stakeholders, relationship with financiers, customers, suppliers, the community and others.

A corporate governance rating is provided by a rating entity after deriving information about the adoption of corporate governance by an institution through the reports of analysts. There are many sources where information can be gathered about the relative standing if an entity with respect to corporate governance. This means a rating agency may or may not actively conduct an audit of an entity before the rating is provided. Given that corporate governance rating is dependent on the information provided on a corporation, it can be modified, suspended or withdrawn if counter information is provided. Some of the processes adopted by rating agencies before coming up with corporate governance rating are macro and microanalysis, crucial data such as proceedings of shareholders meetings, minutes of board meetings, cases filed by consumers, suppliers among others.

Credit Rating in India

1. Credit rating Agency (CRA)

A credit rating agency (CRA) is a company that rates debtors on the basis of their ability to pay back their interests and loan amount on time and the probability of them defaulting. These agencies may also analyse the creditworthiness of debt issuers and provide credit ratings to only organisations and not individuals consumers

2. Credit Rating Information Services of India Limited (CRISIL)

CRISIL stands for Credit Rating Information Services of India Limited and it was the first credit rating agency set up in India in 1987. Today, CRISIL has become a global analytical company that rates companies, researches the markets and provides risk and policy advisory services to its clients. CRISIL provides independent opinion and efficient solutions by performing data analysis and research. It has a strong track record of growth and innovation. The majority shareholder of CRISIL is Standard & Poor's, one of the biggest credit rating agencies of the world. CRISIL works with various governments and policy-makers in India and other developing nations to enhance and improve the infrastructure and meet the demands of the region.

3. Credit Analysis and Research Limited (CARE)

CARE was established in 1993 and since then it has gone on to become India's second largest credit rating agency. CARE has the primary function to perform rating of debt instruments, credit analysis rating, loan rating, corporate governance rating, claims-paying ability of insurance companies, etc. The Information and Advisory Service Department of CARE prepares credit rating and reports on requests from business partners, banks and other financial entities. It also conducts sectorbased studies and provides necessary advisories for valuation, financial restructuring and credit appraisal systems. CARE conducts an extensive research and rates SMEs based on their financial health

4. ICRA

Originally named as Investment Information and Credit Rating Agency, the organisation was set up in 1991. It was a joint venture of Moody's and Indian financial and banking service organisations. It was renamed to ICRA Limited and was listed in the Bombay Stock Exchange and National Stock Exchange in April 2007. ICRA, which is an independent professional corporate investment information and credit rating and advisory agency, is headquartered in Gurugram, Haryana. ICRA assigns corporate governance rating, performance ratings, grading and provides ranking to mutual funds, hospitals and construction and real estate companies.

5. SMERA

SMERA is one such agency that functions exclusively for the sector it was formed for, i.e. Micro, Small and Medium Enterprises. This agency was founded in 2005 by Small Industries Development Bank of India (SIDBI), Dun and Bradstreet Information Services India Private Limited (D&B) and various public, private sector and other MNC banks of India. It is an external credit assessment institution (ECAI). SMERA rates bank loans under Base II guidelines.

6. ONICRA

ONICRA Credit Rating Agency is the private rating agency established by Sonu Mirchandani under ONIDA Finance. The agency provides credit ratings, conducts risk assessment and provides analytical solutions to individuals, corporates and MSMEs. The solutions offered by the agency helps organisations take informed decisions about lending funds to individuals, MSMEs and other organizations.

7. FITCH India

India Ratings and Research (IndRa) is a credit rating agency that provides timebound, accurate and prompt credit opinions. It is 100% owned subsidiary of the Fitch Group. Ind-Ra covers corporate issuers, financial institutions, banks, insurance companies, urban local bodies, structured finance and project finance. Fitch is a major financial information service provider and rating agency having its operations in more than 30 countries across the globe. It checks credit capacity of global leaders in all industries.



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