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Asia Times Online
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South Asia

Jan 21, 2005

India and the case of vanishing companies

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MUMBAI - In its eagerness to "liberalize" the market, the Indian government in 1992 abolished the office of the Controller of Capital Issues and asked the Securities and Exchanges Board of India (SEBI) to monitor the capital market instead. With SEBI's role reduced to vetting Initial Public Offer (IPO) prospectus, many promoters took advantage of the prevailing flux and raised money from the public at fancy premiums. The result: between April 1992 and March 1996, more than 4,000 companies raised over Rs540 billion (US$1.2 billion) from investors through public and hybrid issues, while another 1,500 raised over Rs340 billion through rights issues at high premium. With practically no supervision from either the SEBI, the stock exchanges or the Department of Company Affairs (DCA), many of them then simply vanished.

SEBI and the DCA did not react for several years, and only in the late 1990s did investors see some action - but that was too little, too late. According to Midas Touch Investors' Association, over 1,000 companies have grossly misused funds raised through public issues, defrauding 5 million small investors of Rs100 billion. Investors allege that the stock exchanges, SEBI and DCA failed to take action as ordered by the prime minister, the Allahabad High Court and the Joint Parliamentary Committee in the "vanishing companies" case.

The phenomenon could perhaps find a comparison in the "microcap frauds" in the United States. Microcap companies are typically thinly-capitalized and often not required to file periodic reports with the Securities and Exchange Commission (SEC). However, the SEC, by adopting a four-pronged approach of enforcement, inspection, investor education and regulation, handled the frauds more effectively. In August 1998, the SEC announced 26 enforcement actions against 82 defendants and respondents across the US for engaging in fraudulent microcap schemes. The actions charged all of the participants, including issuers, officers, directors, promoters, accountants, attorneys, broker-dealers and transfer agents. In September 1998, the SEC announced 12 enforcement actions against 38 defendants and in October 1998, 23 against 44 individuals and entities that touted microcap stocks over the Internet without adequately disclosing the compensation they received from the stocks issuers.

Compare this with the Indian scenario, where most scams have involved public listed companies that are required to file periodic information with the stock exchanges and other regulatory bodies, such as the Registrar of Companies (RoC). Further, the SEC has been highly proactive in preventing stock market scams. When plantation company schemes started surfacing for the first time, it acted swiftly by filing a suit against Orange Grove Securities and took the case right up to the US Supreme Court. In India, hundreds of plantation companies were allowed to raise, with impunity, hundreds of billions of rupees from innocent investors in the mid-1990s. By the time the Indian regulators woke up to this mega fraud in 1999, almost all these companies and their promoters had decamped with the public's money.

So far SEBI has done precious little to check the menace of vanishing companies. In fact, the definition that SEBI has for a "vanishing" company is itself faulty. As per SEBI's December 13, 2000 communication to investor associations, companies are classified "vanishing" if they have not complied with listing/filing requirements of stock exchanges/RoCs for two years. Two years is a long time and considering that listed companies are required to submit quarterly reports to the stock exchanges they are listed on, any default in filing or furnishing information to the stock exchanges for more than two successive quarters should set off alarm bells. What prevents SEBI from setting up a system to collate the required information and putting up details of companies and promoters who have not complied with stock exchange requirements for two successive quarters on its website is anybody's guess.

India's stock exchanges seem to be equally reluctant to fight off this problem. All they have done so far is delist shares of companies not complying with listing requirements. Delisting, except for increasing investors' woes, has only encouraged the cause of fraudulent companies and their promoters. The performance of the DCA, which has adequate powers in prosecuting erring promoters and companies, has been even worse.

The problem has been exacerbated by the lack of coordination between SEBI and DCA. Animosity between fellow regulators has led to such a pass that even more than a decade after the 1992 stock scam in India, neither has a conclusive idea of the extent of the cash siphoned off by the fly-by-night companies that tapped the markets. Though thousands of companies have disappeared, taking with them hundreds of billions of rupees from investors, the high-level committee set up to deal with the problem lists only 229 companies as "vanishing", with the amount involved shown as only Rs8 billion. As Oscar Wilde said, "The thief is an artist and the policeman is only a critic."

Such a massive fraud over such a long period could not have been feasible without the connivance of various unscrupulous investment bankers who took these "vanishing" companies public in the first place. Even the auditors were at fault as they toed the management line for pecuniary gains. Many a time, corporate frauds are perpetrated by insiders. This brings us to the issue of corporate governance. As Naresh Chandra, chairman of the Committee on Corporate Audit & Governance constituted by the DCA, said, "Indian companies still have some ground to cover in terms of following corporate governance best practices in substance."

Every vanishing company, such as CRB Corporation, has had chartered accountants who got away unpunished, thanks to the notorious reluctance of the Institute of Chartered Accountants of India to punish dubious members. The number of vanishing companies and those whose securities are hardly, if at all, traded on the bourses is alarmingly high. So are the cases where companies have defaulted on their compliance of listing agreement requirements. In the Indian context, the need for corporate governance has been highlighted because the scams have become almost an annual feature ever since the liberalization process began in 1991 - the Harshad Mehta Scam, Ketan Parikh Scam, UTI Scam, vanishing company Scam, Bhansali Scam ...

With globalization testing the competence of India Inc, many business houses have made great strides in putting in place independent structures and better systems of corporate governance. But many haven't. The Reliance episode, in which the two Ambani brothers are engaged in a tussle to ascertain their power on the ownership of the Rs900 billion giant, is the latest example of falling standards of corporate governance in the country. Boardrooms in India still draw on personal equations rather than accountability.

The example of three directors of the infamous Global Trust Bank exiting the board without giving any explanation for the way the bank went bust is but one of the numerous examples of corporate irresponsibility in India. A large part of the non-performing assets of banks and financial institutions, estimated at over Rs1,100 billion, has piled up because of the willful default by company managements. If Indian corporates have to take their rightful place in the world market, they will first have to learn taking responsibility.

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