CORPORATE GOVERNANCE IN INDIA

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A corporation is a congregation of various stakeholders, namely, customers, employees, investors, vendor partners, government and society. A corporation should be fair and transparent to its stakeholders in all its transactions. This has become imperative in today's globalized business world where corporations need to access global pools of capital, need to attract and retain the best human capital from various parts of the world, need to partner with vendors on mega collaborations and need to live in harmony with the community. Unless a corporation embraces and demonstrates ethical conduct, it will not be able to succeed.

Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation or company is directed, administered or controlled. Corporate governance also includes the relationships among the many

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stakeholders involved and the goals for which the corporation is governed.

Corporate Governance is the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed and how performance is optimized. Sound Corporate Governance is, therefore, critical to enhance and retain investor's trust.

Definition of Corporate Governance

Report of SEBI Committee (India) on Corporate Governance defines corporate governance as "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 & corporate funds in the management of a company."[1]

The OECD provides the most authoritative functional definition of corporate governance: "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers,

[1] N. R Narayana Murthy, "Report of the SEBI Committee on Corporate Governance." p.5, http://www.sebi.gov.in/commreport/corpgov.pdf. last visited on 14.10.2010.

shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."[2]

History of Corporate Governance in India: A Background

The history of the development of Indian corporate laws has been marked by interesting contrasts. At independence, India inherited one of the world's poorest economies but one which had a factory sector accounting for a tenth of the national product; four functioning stock markets with clearly defined rules governing listing, trading and settlements; a well-developed equity culture if only among the urban rich; and a banking system replete with well-developed lending norms and recovery procedures.[3] In terms of corporate laws and financial system, therefore, India emerged far better endowed than most other colonies.

The years since liberalization, have witnessed wide-ranging changes in both laws and regulations driving corporate governance as well as general consciousness about it. Perhaps the single most important development in the field of corporate governance and investor protection in India has been the

[2] http://www.ccg.uts.edu.au/corporate_governance.htm last visited on 14.10.2010.

[3] Rajesh Chakrabarti, 'Corporate Governance in India – Evolution and Challenges'. http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN023826.pdf, last visited on 4.10.2010.

establishment of the Securities and Exchange Board of India (SEBI) in 1992 and its gradual empowerment since then.[4] Established primarily to regulate and monitor stock trading, it has played a crucial role in establishing the basic minimum ground rules of corporate conduct in the country.

Concerns about corporate governance in India were, however, largely triggered by a spate of crises in the early 90's – the Harshad Mehta stock market scam of 1992 followed by incidents of companies allotting preferential shares to their promoters at deeply discounted prices as well as those of companies simply disappearing with investors' money.

Corporate governance in India is evident from the various legal and regulatory frameworks and Committees set relating to corporate functioning comprising of the following[5]:

- The Companies Act, 1956
- Monopolies and Restrictive Trade Practices Act, 1969 (replaced by new Competition Law)
- Foreign Exchange Management Act, 2000
- Securities and Exchange Board of India Act, 1992
- Securities Contract Regulation Act, 1956
- The Depositories Act, 1996
- Arbitration and Conciliation Act, 1996
- SEBI Code on Corporate Governance

[4] Ibid.

[5] http://www.ss-associates.com/CORPORATEGOVERNANCEININDIA.pdf last visited on 15.10.2010.

Apart from these Acts many committees have been set up over the years to legislate the concept called 'corporate governance'.

1) Desirable Code of Corporate Governance (1998)

Corporate governance has been a buzzword in India since 1998. On account of the interest generated by Cadbury Committee Report (1992) in UK corporate governance initiatives in India began in 1998 with the Desirable Code of Corporate Governance – a voluntary code published by the Confederation of Indian Industry (CII), and the first formal regulatory framework for listed companies specifically for corporate governance, established by the SEBI.[6] The CII Code on corporate governance recommended that the key information to be reported, listed companies to have audit committees, corporate to give a statement on value addition, consolidation of accounts to be optional. Main emphasis was on transparency.

2) Committee on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla (1999).

The Kumar Mangalam Committee made mandatory and non-mandatory recommendations. Based on the recommendations of the Committee, the SEBI had specified principles of Corporate Governance and introduced a new clause 49 in the Listing agreement of the Stock Exchanges in the year 2000.

[6] Supra Note 1, last visited on 15.10.2010.

3) Naresh Chandra Committee (2002)

The Enron debacle in July 2002, involving the hand-in-glove relationship between the auditor and the corporate client and various other scams in the United States, and the consequent enactment of the stringent Sarbanes – Oxley Act in the United States were some important factors, which led the Indian government to wake up. The Department of Company Affairs in the Ministry of Finance on 21 August 2002, appointed a high level committee, popularly known as the Naresh Chandra Committee, to examine various corporate governance issues and to recommend changes in the diverse areas involving the auditor-client relationships and the role of independent directors.

The Committee submitted its Report on 23 December 2002. Naresh Chandra Committee recommendations relate to the Auditor-Company relationship and the role of Auditors. Report of the SEBI Committee on Corporate Governance recommended that the mandatory recommendations on matters of disclosure of contingent liabilities, CEO/CFO Certification, definition of Independent Director, independence of Audit Committee and independent director exemptions in the report of the Naresh Chandra Committee, relating to corporate governance, be implemented by SEBI.

4) Committee on Corporate Governance under the Chairmanship of Shri N. R. Narayana Murthy (2002)

Narayana Murthy Committee recommendations to clause 49 of the Listing Agreement, include role of Audit Committee, Related party transactions, Risk management, compensation to Non-Executive Directors, Whistle Blower Policy, Affairs of Subsidiary Companies, Analyst Reports and other non-mandatory recommendations.

Corporate Governance under Clause 49 of the Listing Agreement

Clause 49 of the Listing Agreement, which deals with Corporate Governance norms that a listed entity should follow, was first introduced in the financial year 2000-01 based on recommendations of Kumar Mangalam Birla committee. After these recommendations were in place for about two years, SEBI, in order to evaluate the adequacy of the existing practices and to further improve the existing practices set up a committee under the Chairmanship of Mr Narayana Murthy during 2002-03.

The Murthy committee, after holding three meetings, had submitted the draft recommendations on corporate governance norms.[7] After deliberations, SEBI accepted the recommendations in August 2003 and asked the Stock Exchanges to revise Clause 49 of the Listing Agreement based on Murthy committee recommendations. This led to widespread protests and representations from the Industry thereby forcing the Murthy committee to meet again to consider the objections. The committee, thereafter, considerably revised the earlier

[7] Supra Note 1, last visited on 16.10.2010.

recommendations and the same was put up on SEBI website on 15th December 2003 for public comments. It was only on 29th October 2004 that SEBI finally announced revised Clause 49, which had to be implemented by the end of financial year 2004-05. These revised recommendations have also considerably diluted the original Murthy Committee recommendations.

Areas where major changes were made include:

- Independence of Directors
- Whistle Blower policy
- Performance evaluation of nonexecutive directors
- Mandatory training of non-executive directors, etc.

Failure to comply with clause 49 (corporate governance) of SEBI's listing agreement is punishable with imprisonment of up to 10 years or a fine of up to Rs 25 crore or both. Besides, stock exchanges can suspend the dealing/trading of securities.

With over 6000 listed companies, monitoring and enforcement are significant challenges in the immediate term. While SEBI's ultimate sanction in cases of serial non-compliance is delisting, this is unpopular as delisting penalises the non-controlling dispersed shareholders and closes their exit options. Hence, SEBI has tended to enforce the recommendations through dialog and in some cases monetary penalties.[8]

[8] For example in September 2007, SEBI imposed monetary penalties on 20 companies which did not comply with Clause 49 (The Economic Times, 2007). The identity of these 20 companies were however, not disclosed. Rounding up 20 companies for disciplinary action seems to be a small step compared to the perceived number of non-compliant companies remaining to be acted against.

Corporate Governance under Companies Act, 1956

The Companies Act, 1956 is the central legislation in India that empowers the Central Government to regulate the formation, financing, functioning and winding up of companies. It applies to whole of India and to all types of companies.[9]

The Companies Act, 1956 has elaborate provisions relating to the Governance of Companies, which deals with management and administration of companies. It contains special provisions with respect to the accounts and audit, director's remuneration, other financial and nonfinancial disclosures, corporate democracy, prevention of mismanagement, etc.

- **Disclosures on Remuneration of Directors**

The specific disclosures on the remuneration of directors regarding all elements of remuneration package of all the directors should be made as a part of Corporate Governance. Section 299 of the Act requires every director of a company to make disclosure, at the Board meeting, of the nature of his concern or interest in a contract or arrangement (present or proposed) entered by or on behalf of the company.[10] The company is also required to record such transactions in the Register of Contract under section 301 of the Act.

- **Requirements of the Audit Committee**

Audit Committee has a critical role to play in ensuring the

[9] http://business.gov.in/corporate_governance/companies_laws.php last visited on 6.10.2010.

[10] http://www.iiaindia.org/docs/companies%20act%20proviso%20on%20CG.doc. last visited on 16.10.2010.

integrity of financial management of the company. This Committee add assurance to the shareholders that the auditors, who act on their behalf, are in a position to safeguard their interests. Besides the requirements of Clause 49, section 292A of the Act requires every public having paid up capital of Rs 5 crores or more shall constitute a committee of the board to be known as Audit Committee.[11]

As per the Act, the committee shall consist of at least three directors; two-third of the total strength shall be directors other than managing or whole time directors. The Annual Report of the company shall disclose the composition of the Audit Committee.[12]

If the default is made in complying with the said provision of the Act, then the company and every officer in default shall be punishable with imprisonment for a term extending to a year or with fine up to Rs 50000 or both.

- **Number of Directorships Restricted**

Sections 275, 276 and 277 have been amended to provide that no person shall hold office as director in more than 15 companies (excluding private company, unlimited company, etc., as defined in section 278) instead of 20 companies. This shall enable the director concerned to devote more time to the affairs

[11] Supra Note 10.

[12] The recommendations of the committee on any matter relating to financial anagement including Audit Report, shall be binding on the board. In case board does not accept the recommendations so made, the committee shall record the reasons thereof, which should be communicated to the shareholders, probably through the Corporate Governance Report.

of company in which he is a director.[13]

- **Corporate Democracy**

Wider participation by the shareholders in the decision-making process is a pre-condition for democratizing corporate bodies. Due to geographical distance or other practical problems, a substantially large number of shareholders cannot attend the general meetings. To overcome these obstacles and pave way for introduction of real corporate democracy, section 192A of the Act and the Companies (Passing of Resolution by Postal allot), Rules provides for certain resolutions to be approved and passed by the shareholders through postal ballots.

- **Appointment of Nominee Director by Small Shareholders**

Section 252 has been amended to provide that a public company having paid-up capital of Rs. 5 crore or more and one thousand or more small shareholders can elect a director by small shareholders. "Small shareholders" means a shareholder holding shares of nominal value of Rs. 20,000 or less in a company.[14] However, this provision is not mandatory and small shareholders have option to elect a person as their representative for appointment as director on the Board of such company.

- **Directors' Responsibility Statement**

Sub-section (2AA) in section 217A has provided that the Board's report shall include a directors' responsibility statement

[13] http://articles.manupatra.com/PopOpenArticle.aspx?ID=729b115f-d9c6-44ea-be22- b00d73f61f0d&txtsearch=C.M.%20Bindal* last visited on 17.10.2010.

[14] Supra Note 9, last visited on 17.10.2010.

with respect to applicable accounting standards having been followed, consistent application of accounting policies selected so as to give a true and fair view of state of affairs and of the profit and loss of the company, maintenance of adequate accounting records with proper care for safeguarding assets of company and to prevent and detect fraud and other irregularities, and the preparation of annual accounts on a going concern basis.

Conclusion

With the recent spate of corporate scandals and the subsequent interest in corporate governance, a plethora of corporate governance norms and standards have sprouted around the globe. After the Satyam Scandal, corporate governance, which is the system that helps firms control and direct operations, is in the spotlight as key parts of the governance framework such as audit and finance functions have failed to check the promoter-driven agendas.

Corporate governance extends beyond corporate law. Its objective is not mere fulfilment of legal requirements but ensuring commitment on managing transparentcy for maximising shareholder values. As competition increases, technology pronounces the deal of distance and speeds up communication, environment also changes. In this dynamic environment, the systems of Corporate Governance also need to evolve, upgrade in time with the rapidly changing economic and industrial climate of the country.