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Corporate Governance in India: Regulatory Reforms

Introduction

The Organisation for Economic Co-operation and Development (OECD) Principles define corporate governance as a structure involving interaction between managers of the company, the board, shareholders and other stakeholders. This enables the board to govern the company in a manner to achieve maximisation of owners' wealth and protection of the interests of other stakeholders.

The International Finance Corporation (IFC) also defines corporate governance as the inter-relationship between the various stakeholders like management, board, majority shareholders and minority shareholders etc.

The idea of corporate governance gained prominence after the 1992 release of the "Report of the Committee on the Financial Aspects of Corporate Governance". This report, known as the Cadbury Report after Committee head Sir Adrian Cadbury, is considered to be the cornerstone of corporate governance.

The Cadbury Committee defines corporate governance as the system by which companies are directed and controlled. The Cadbury Committee Report was instrumental in bringing changes in the corporate governance norms of several jurisdictions including India.

In the Indian context, the definition of corporate governance is well laid down by the N R Narayana Murthy Committee on Corporate Governance (2002) which was appointed by the Securities and Exchange Board of India (SEBI), the securities market regulator. The Murthy Committee stated; "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".

Why Corporate Governance?

As rightly pointed out by the Uday Kotak Committee, set up in 2017, corporate governance is a mechanism to ensure fair treatment to all the stakeholders of a company, more particularly, the small investors.

According to Sarkar and Sen (2012) companies practicing sound corporate governance standards tend to give better returns than the companies that do not adhere to corporate governance standards. Therefore, it is essential that the principles of corporate governance are adhered to by all the stakeholders, not only in letter but also in spirit. However, recently, it is observed that many undesirable governance practices are being adopted by some reputable companies. Therefore, the main objective of corporate governance norm is to shape the governance structure of companies for long-term value creation and to protect the interests of all stakeholders.

If an economy has not adopted sound corporate governance principles, it will not be a desired destination for foreign capital or investors will seek higher return on their capital as a risk premium. As former U.S. Securities and Exchange Commission (SEC) Chairman Arthur J. Levitt, Jr. (December, 2000) rightly said "If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises within that country regardless of how steadfast a particular company's practices may be – suffer the consequences".

Theories of Corporate Governance

There are various theoretical frameworks regarding corporate governance. The major theories are as follows.

1. **Agency Theory,** propounded by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976), is based on the premise that the goals of the agents and principals are different and conflicting. The principals (shareholders) want to maximise the value of the firm while the agents, the management, sometimes make decisions which are not in the interest of shareholders but merely further their own interests. Therefore, there is need of incentivising the executives to work for the interests of the principals as well as requiring the board of directors to control and supervise them.

   According to agency theory, in order to protect the interests of the principals, the board of the company strictly controls, supervises, and monitors the performance of the agent (Hillman & Dalziel, 2003). In other words, the board is accountable to shareholders and there is active involvement of the board in decision-making.

2. **Resource-Dependence Theory** proposed by Hillman, Canella and Paetzold (2000) focuses on the role of the directors in arranging necessary resources for the organisation. Decision-making responsibility lies with the executives, subject to some approval by the board of directors. The board members with knowledge and expertise can mentor the executives in order to improve the efficiency and skill sets of the executives.

3. **Stakeholder Theory** was developed by Freeman (1984) incorporating corporate accountability to a broad range of stakeholders, apart from shareholders. Freeman (1984) believes that executives and managers in organisations have a network of relationships to serve. He also argues that this network is important in addition to the owner-manager-employee relationship as in agency theory. Thus according to Freeman (1984), organisations managing their stakeholder relationships out-perform and outlive other organisations.

4. **Stewardship Theory** is formulated by Davis and Donaldson (1991). The theory lays emphasis on top management and executive acting as stewards and protecting and maximising shareholders' wealth. In order to achieve maximisation of shareholders' wealth, good performance is a *sine-qua-non*. According to stewardship theory, unification of the roles of CEO and Chairman would achieve better outcomes and also mitigate agency costs.

Corporate Governance in India

Indian economy and regulatory framework for companies issuing securities in India

Among the major economies in the world, India is at present one of the fastest growing economies. Currently, India is growing around at the rate of seven per cent per annum and it is the third largest economy in terms of purchasing power parity (PPP) and seventh largest in terms of nominal exchange as per country data provided by the World Bank.

India has been in the forefront of nations in adopting corporate governance standards. Further, SEBI's mandate also lists investor protection as a main priority of the regulator. This is reflected in the latest World Bank Report titled "Doing Business – Measuring Business Regulations" which ranks India fourth in terms of protecting minority investors. In this pursuit, Indian regulators have set up committees under eminent industrialists to prescribe a governance standard for the corporates.

As shown in Table 1, the number of companies registered on Indian stock exchanges is high and the market cap to gross domestic product (GDP) ratio also indicates the relative size of Indian stock markets as compared to economy.

The impact of adoption of corporate governance on market valuation in India has been studied by Banerji, Gokarn, Pattanayak and Sinha (2009). They analysed whether firms in India receive better market valuations on adopting corporate governance practices and studied the relationship between corporate governance and firm level performance in Indian markets using the corporate governance score (Gscore) from the S&P ESG India Index as an indicator for firm level governance quality and financial ratios like leverage ratios, return on net worth (RONW), return on capital employed (ROCE) as indicators for firm level performance. Tobin's Q was used as an indicator of market valuation. They found that the Gscores of In-

Table1: Economic Indicators for India

	FY 2017-18
GDP (Current Prices)	USD 2.264 trillion

	As of March 2017		
Stock Exchanges	No of Listed Companies	Market Capitalisation	Market Cap/ GDP Ratio
BSE	5,834	INR 121 trillion	80%
National Stock Exchange of India (NSE)	1,817	INR 119 trillion	78.9%

	FY2014-15	FY2015-16	FY2016-17
Net Foreign Portfolio Investment (in USD Million)	45,698	-2,523	7,177

Source: World Development Indicators (www.data.worldbank.org), SEBI Annual Report 2016-17 dian companies as measured by S&P ESG India Index is symmetrically distributed. Using regression, they found that corporate governance is a significant variable in market valuation of Indian companies. The other variables were also found significant. The regression results show that *ceteris paribus* an increase in corporate governance score by one unit results in an increase in market valuation by 0.03 units. Thus, according Banerji, Gokarn et al., in India there is a positive and significant relationship between corporate governance and firm level performance and market valuation. Better governed firms receive higher market valuation in Indian markets.

Improved standards of transparency, disclosure, and governance norms are significant for India as they would encourage more foreign investment in Indian companies and also ease Indian companies' mobilisation of funds from international markets. It is noteworthy that corporate governance is a key measure of performance that global investors factor in and the optimism exhibited by international financial institutions on the Indian economy is based on enhanced corporate governance standards. The regulatory framework set up by SEBI through empowerment of minority shareholders' rights and the activism of institutional shareholders has led Indian companies to improve their corporate governance.

The Companies Act, 2013 regulates all entities incorporated in the form of a company and is administered by the Ministry of Corporate Affairs. It has replaced the Companies Act, 1956 which had minimal provisions for overseeing the governance of companies. In respect of listed companies, SEBI has been empowered by the Securities Contracts (Regulation) Act, 1956 (SCRA) and the SEBI Act, 1992, to prescribe norms for complying with corporate governance requirements. These three pieces of legislation along with the Depositories Act, 1996 (providing for trading in electronic form of securities), enacted by the Indian Parliament, are the pillars of the Indian securities market.

Companies raising funds through the securities market have to abide by the rules and regulations prescribed by SEBI. At the time of raising the capital through issuance of securities to the public, companies have to make initial disclosures to enable investors to decide whether or not to subscribe to securities issued by the company. Companies are mandated to list their securities on the stock exchange if they raise money from 2 hundred or more individual investors during a financial year. (The requirement was 50 or more investors under the earlier Companies Act, 1956). The regulations also facilitate investors buying and selling securities through off-market transfers and transfers of physical shares among themselves but this is quite cumbersome compared to trades on stock exchange.

The functioning of the stock exchanges is prescribed in the SCRA which also lays down the definition of securities and the recognition and regulation of stock exchanges as well as means to prevent undesirable transactions in financial contracts, among other measures.

The SCRA also mandates that every company which intends to mobilise capital through initial public offering (IPO) enter into a "Listing Agreement" with the recognised stock exchange, where the securities are proposed to be listed and it empowers SEBI to issue directions to a company whose securities are listed or proposed to be listed on a recognised stock exchange.

Evolution of corporate governance in India

The concept of corporate governance gained prominence in India after the country opened its gates to economic liberalisation and globalisation in the 1990s. The major changes in economic policy such as the establishment of SEBI in 1992 (replacing the erstwhile controller of capital markets), the shift from an "approval-based regime" to a "disclosure-based regime," and the appetite amongst companies for accessing foreign capital made companies exhibit greater accountability to shareholders and other stakeholders.

The following paragraphs discuss in detail the contribution made by various institutions like Confederation of Indian Industry (CII), the securities market regulator and the government of India.

1. CII took the first step in formulating a code for corporate governance in India with the announcement of "Desirable Corporate Governance – A Code" in 1998. This initiative was more of a voluntary code of expectations to be complied with by companies, both in the public and private sectors including banks and financial institutions.

   The CII Code stressed maximisation of shareholders. Its key recommendations include a single board instead of the two-tier board adopted in some countries, a cap on the number of directorships in listed companies, and the setting up of audit committees by companies with turnover or paid-up capital above a certain threshold.

2. In 2009, the Ministry of Corporate Affairs, issued "Voluntary Guidelines on Corporate Governance" which prescribed best governance practices for public companies. The ministry also appointed another committee in 2012 under the chairmanship of Adi Godrej, Chairman of the Godrej Group, which came up with seven guiding principles of corporate governance for public companies.

   The accounting scandals in the early 2000s involving Enron, Worldcom, Xerox, AOL, Satyam, global financial crisis and others prompted the Ministry of Company Affairs to carry out a major overhaul by replacing the old Companies Act, 1956 with the new Companies Act, 2013. The new Act strengthened the norms for companies by introducing provisions such as the concept of independent directors (IDs), a code of conduct and remuneration of IDs, limit on the number of directorships, a board evaluation process, the role and responsibility of the audit committee and other committees, and a whistle blower mechanism. The listing agreement was also modified as per the new Companies Act.

3. SEBI had taken a number of initiatives for improving the governance standards of listed entities in India by setting up committees to study the functioning of company boards and formulate an appropriate policy framework to improve their functioning so that the interests of all the stakeholders, especially the minority shareholders, are protected.

   The various steps taken by SEBI from 1999 to date in the area of corporate governance and the resultant regulatory changes brought are captured in Table 2.

Transition from Listing Agreement to SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015

Companies raising capital through public issue were required to enter into a

Table 2: SEBI Initiatives and Resulting Regulatory Changes from 1999 to Date

Year	Particulars of the Committee	Rationale	Major Policy Initiative or Announcement
1999	Committee chaired by Kumarmangalam Birla, member of the SEBI Board	• Money mobilisation by many unscrupulous companies from the capital market at a very high premium • Preferential allotment of shares made to promoters at convenient prices by some companies • Lacuna in attending to investor grievances and providing services to investors • Evolution of best corporate governance practices across the world through the Cadbury Committee Report	Introduction of Clause 49 in the Listing Agreement for exclusively dealing with the corporate governance issues of listed entities including the following: • Optimum combination of executive and non-executive directors in company boards • Meetings of the board of directors at regular intervals • Independent audit committee to examine company financials and provide detailed information to shareholders for appointment/re-appointment of directors
2003	Committee chaired by N R Narayanam-Murthy, Chairman and Chief Mentor, Infosys Technologies	Corporate scandals across the world, especially in U.S., led governments to enact stringent laws to restore investor confidence and improve standards. SEBI committee to align the existing framework with new global standards	Inclusion of new provisions in the listing agreement: • Strengthening the parameters for appointment to the audit committee and for empanelment of external auditors • Audit committee to examine the financial statements, audit qualifications and related party transactions • Company boards to review the business risks and put in place mechanisms to control and minimise risks by seeking appropriate reports from management • Introduction of whistle-blower mechanism to encourage personnel to report unethical practices to the audit committee

listing agreement with the stock exchanges for each class of security, i.e., equity, debt, depository receipts, etc.

The Listing Agreements lay down responsibilities of companies, such as assisting investors in the transfer of securities, receiving corporate benefits etc., and providing adequate disclosure and governance through various board committees.

Companies that had raised capital by issuance of equity were required to enter into another listing agreement to raise capital through debentures or another class of security. This made adhering to disclosure requirements under different listing agreements difficult.

- **Difficulty with separate Listing Agreements:** The regulator and the stock exchanges also found it difficult to enforce the Listing Agreement as the range of powers available under SEBI Act, 1992 could not be effectively enforced in case the company violated the listing agreement.

According to the SEBI Approach Paper on Listing Obligations and Disclosure Requirements (2014) and the agenda note for the SEBI board meeting on 19 November, 2014 International Monetary Fund's (IMF) Financial Sector Assessment Program (FSAP) on India also observed the limitations in terms of enforceability in the mechanism for recognised stock exchanges to ensure listing compliance and suggested that the mechanism could be strengthened by SEBI along with stock exchanges.

- **Review of international framework of disclosures and listing compliance:** On reviewing other countries' frameworks for ensuring continuous disclosures and listing compliance, it was found that typically a specific department of the regulator regulated listing compliance and continuous disclosures, for example, the Corporate Finance Department of the SEC, the Company Monitoring Team of the UK Financial Services Authority and the Issuer Unit of the Australian Securities Exchange.

Thus, for India, harmonisation of the provisions of the Companies Act, 2013 and the Listing Agreement became imperative to regulate continuous disclosures by listed entities. As a result, the Listing Agreement has been converted into a regulation called SEBI Listing Obligations and Disclosures Requirements Regulations, 2015 (LODR). This regulation came into force upon notification in *Government of India Gazette* on 2 September, 2015.

- **Applicability of LODR:** LODR is applicable to specified securities listed on the Main Board, the Small and Medium Enterprises (SME) platform and the Institutional Trading Platform (ITP), non-convertible debt instruments like preference shares, bonds and debentures, securitised debt instruments, units of mutual funds, Indian Depository Receipts and any other securities that may be specified by SEBI.

The substantive requirements are incorporated in the main body of LODR and the procedural requirements are included in the schedules to the regulations. In order to adopt best practices and international benchmarks, the International Organisation of Securities Commission (IOSCO) Principles for periodic disclosures by listed entities and OECD Principles of Corporate Governance were incorporated into LODR. The provisions related to corporate governance in the Companies Act, 2013 were also incorporated in LODR.

Some of the salient features of the LODR is as follows:

1) For the sake of clarity, the compliance obligations of companies are bifurcated into Common Obligations, which are applicable to all listed companies, and include appointing key managerial personnel, disclosures, document policy, and investor services, and Specific Obligations, which are applicable according to the type of security listed on the stock exchange.

2) The LODR disclosure standard mandates that the listed company shall apply the materiality concept (approved by the company's board) while making disclosures and consider events or information whose omission would cause discontinuity or alteration of events or alteration of information already available and would cause significant market reaction. For instance, commencement of production, change in nature of business, and capacity addition, litigation disputes.

   Continuous disclosures include disclosures on shareholding pattern, financials, acquisitions, issuance of security, and outcome of board meetings and shareholders meetings.

3) LODR and Companies Act, 2013 prescribe more or less uniform requirements for board composition, need for independent directors and at least one woman independent director on the board. The role of independent directors to evaluate board performance is also prescribed.

4) LODR prescribes that directors and key management personnel declare any conflict of interest.

5) To regulate subsidiaries and to prevent related party transactions, the LODR (2014) also defines a material subsidiary as a subsidiary whose income or net worth exceeds twenty percent of the consolidated income or net worth respectively of the listed entity and its subsidiaries in the immediately preceding accounting year.

The Way Forward

Two years after the notification of the LODR Regulations, it was felt that the governance practices of even the most reputed public listed companies were not up to the mark on many dimensions including board diversity, reliability of disclosures, role of independent directors, protection of minority shareholder interests, managerial compensation and related party transactions. Therefore, in order to further fine tune the governance framework of the listed companies, SEBI formed a committee under the chairmanship of Uday Kotak, Executive Vice Chairman and Managing Director of Kotak Mahindra Bank. The other factors which necessitated reviewing the governance practices of companies include the increasing pace of change in market conditions, the obsessive focus of companies on short-term performance at the cost of long-term performance and an increasingly complex regulatory environment.

The Kotak Committee was requested to make recommendations to SEBI on the following:

- Mechanisms to ensure independence of the institution of independent directors and their effective contribution to the board,
- Enhancing the disclosure requirements and approval process for related party transactions,
- Reviewing the accounting and auditing issues of listed companies,
- Redesigning the board evaluation process, and
- Strengthening the voting mechanism and shareholders' effective participation in meetings.

The committee submitted its report to SEBI in October 2017. Its noteworthy recommendations included the following:

- Separating the roles of Chairperson (head of the board) and Managing Director or Chief Executive Officer (head of management) to provide a more balanced governance structure by enabling better and more effective supervision of management;
- Appointment of at least one woman independent director to the board as gender diversity would have a positive impact on the decision making process of companies;
- Restriction on the maximum number of directorships held by executive and non-executive directors as the considered that a director holding multiple directorships above a reasonable threshold may not be able to allocate sufficient time to a particular company and as a result, may not be able to contribute effectively to the board;
- Considering the critical role of independent directors in maintaining effective corporate governance, the committee recognised the importance of ensuring the "independence" of the independent directors. Therefore, it recommended an effective mechanism for both objective and subjective assessment of the role, responsibility, qualification and training of the independent directors;
- Enhancement of the role of the audit committee especially for scrutinizing the end utilisation of funds to subsidiaries above a certain threshold;
- Effective role of the nomination and remuneration committee in recommending senior executive compensation above a certain threshold; and
- Setting up a separate unit or committee to monitor group governance in the case of listed entities with a large number of unlisted subsidiaries.

SEBI accepted the majority of the committee's recommendations, including those highlighted above, and put in place a strong regulatory framework for the governance of listed companies in India by amending the SEBI LODR Regulations in May 2018. In order to study their effectiveness, SEBI has made many of the changes applicable to the top one hundred or five hundred companies in terms of market capitalisation. Based on the impact of the recent amendments on the governance behaviour of the companies, SEBI may extend applicability of these provisions to other companies also.

It is worthwhile to mention that the corporate governance framework in India has been severely tested from time to time. Though there have been instances of corporate impropriety and fabrication of material information due to the misbehaviour of a few individuals, the boards of directors of the affected companies along with regulatory support played an effective role in finding strategic buyers and preventing bankruptcy. It may be highlighted that the whistle-blowing mechanism now mandated by the regulator has enabled stakeholders to call attention to questionable practices, even involving top management and it did prevented the companies from sweeping conflict of interest issues under the carpet. This indicates how the corporate governance framework has delivered in most circumstances, albeit there have been a few instances where the board has been unable to track due to the fraudulent design of the offenders.

The insolvency and bankruptcy framework enacted by the Parliament of India through the Insolvency and Bankruptcy Code, 2016, enables creditors, home buyers and other stakeholders of a listed company to invoke the provisions for liquidation or resolution in case the company fails to fulfill its contractual obligations, thereby making companies accountable to all the stakeholders. As such, it has become imperative that the boards maintain the financial viability of firms by adopting rigorous standards of corporate governance.

Nevertheless, it may be added that most of the latest amendments to LODR will not come into effect until FY2019-2020 and therefore, we may have to wait for a year or so to understand the impact of the new corporate governance framework and also the value the amendments add to the effective functioning of the boards of listed companies in India.

The views expressed here are solely those of authors in their personal capacities and do not any way represent the views of the organisation(s) they are associated with.

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