UNIT 12 INVESTORS' PROTECTION AND CORPORATE GOVERNANCE

Structure

12.0 OBJECTIVES

After studying this unit you should be able to :

- appreciate the need for investors' protection;
- identify the provision made in various acts for investors' protection and the role of SEBI in this regard;
- explain the concept of corporate governance;
- state the broad objectives of corporate governance;
- emphasise on accountability as the key to good governance;
- outline the requisites of good governance;
- identify steps taken to ensure good corporate governance;
- explain the requirements of Corporate Governance Code and Clause 49 of the listing agreement;
- state the relevant provisions of the Companies (Amendment) Act, 2000; and
- identify the new challenges with respect to good corporate governance.

12.1 INTRODUCTION

The growth of India's capital market, after the reformist economic policies announced in 1991, has brought about increasing awareness of investment opportunities and interest in stock market operations among the general public. More than that, a sizable number of individual investors who earlier shied away from the securities markets and trusted bank deposits and post office savings schemes, have shown a marked preference for investment in corporate securities (shares and debentures). This preference is partly attributable to growing awareness of new long-term investment opportunities in the securities market and partly due to the facility of electronic trading system across the country, introduced by NSE and followed by BSE. However, many retail investors have suffered due to unhealthy speculation in stock markets, manipulation of operations and unfair dealings in securities on the part of promoters. It is observed that the interest of minority shareholders and individual investors is often ignored by promoters/ directors of companies so as to serve their personal interest. Thus, while investors' protection is called for against manipulative practices in securities transactions, it is also linked with good corporate governance involving corporate responsibility and directors' accountability to the stakeholders.

You have learnt about the regulatory framework for controlling the operations at the stock exchanges and SEBI's role in this context in Unit 11. In this unit you will learn about the need for investors' protection, the role of SEBI in building investors' awareness and handling their grievances, and the concept of corporate governance, its role in strengthening investors confidence and the steps taken to ensure good corporate governance. In addition, you will learn the details of Corporate Governance Code under Clause 49 of the listing agreements, provisions of the Companies (Amendment) Act, 2000, and the renewed challenges in this context.

12.2 NEED FOR INVESTORS' PROTECTION

Individual investors including small investors generally come to know about investment opportunities in corporate securities from write ups in business newspapers and financial journals. They may subscribe to initial public offers of debt/equity on the basis of newspaper reports or on the advice of brokers/commission agents, and invest in existing shares on the basis of market trends, their track record, dividend payment, etc. These investors need to be protected against losses that they are likely to suffer on account of lack information and various lacunae, lapses, and malpractices in the securities market. The more important of these are given below.

1 Public issues of shares by companies are often announced with attractive prospects of dividend distribution and growth which may be exaggerated, if not misleading. Promoters of greenfield companies are often able to allure gullible individual investors due to their inability to judge the credibility of the prospects.

2 Public issues of shares by existing companies are known to attract subscription on the basis of track record of the concerned enterprise. Past performance is usually reflected in the financial statements of the company which, in many cases, are lacking in transparency. Fresh issue of equity may be linked with expansion projects which involve risks of loses on account of uncertainties in future..

3 Investors are mostly attracted by the rising security prices and invest in shares of listed companies to derive the benefit of capital appreciation over time. But, such trend may not persist as prices are highly sensitive and are subject to wide fluctuations. Not only that, the stock market quotations do not usually reflect the intrinsic value of existing shares.

4 There are many listed companies having less than 100 public shareholders. Some of these companies are sold, sometimes at a huge premium for reverse mergers, whereby an unlisted company may be listed without having to make a public issue. In such cases, promoters may manipulate share prices during bull runs and sell their holdings to small investors at highly inflated price.

5 Deficiencies in corporate governance also affect investors' interest, transparency in financial reporting and accountability of directors with respect to their responsibility towards minority shareholders and small investors.

6 Above all, there is the retail investors' ignorance about their rights as shareholders, absence of due diligence in the matter of financial and legal implications of corporate shareholding, and delay in the redressal of investors' complaints and grievances.

12.3 PROTECTION OF INVESTORS' INTERESTS – AN OVERVIEW

In order to protect investors' interests, a variety of provisions have been made in the Companies Act, the Securities Contracts (Regulation) Act and the SEBI Act. The Companies Act, for example, contains provisions in respect of issue of capital, appointment of managerial personnel, limits on managerial remuneration, disclosure of important information, special audit, inspection and investigation, protection of minority interests, etc. The Securities Contracts (Regulation) Act provides for the recognition of stock exchanges, general control over their trading methods and practices, regulation of contracts in securities, listing of securities, etc. As for SEBI, it was set up as a non-statutory body in 1988 to regulate the capital market. It became a statutory board under SEBI Act in 1992 and has been made the administrative authority for enforcement of the provisions of the Companies Act with respect to several aspects of capital issues. It has issued SEBI (Disclosure and Investor Protection) Guidelines which are applicable to all public issues of capital and offers of sale by listed and unlisted companies.

You have learnt about the above measures in Unit 11. However, SEBI plays a much wider role in protection of investors. It has been taking up a number steps to educate the investors through various programmes such as SMAC (Securities Market Awareness Campaign) which conducts workshops all over the country to acclimatise the investors with the functioning of the securities market, preparing a standardised reading material and audio-video clips on topics concerning investors, placing an investor website (http ://semi investor.gov.in), setting up a simple and effective internet based response to investors' complaints, and issuing advertisements relating to various aspects of securities market. Another important activity of SEBI relates to taking up investors' grievances on matters related to IPOs and capital market operations against the intermediaries registered with it and get them redressed, and undertake investigation in respect of issue related and market related matters such as market manipulation, price rigging issue related manipulation, insider trading, takeovers, etc. Thus, the investors are getting adequately educated and protected in primary and secondary markets. Of course, a lot more still retrains to be done and there is need for further strengthening the hands of SEBI with more legal and judiciary powers. powers in this regard.

Check Your Progress A

1 State any three reasons emphasising the need for investors' protection.

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2 State any three steps taken by SEBI to educate the investors.

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3 Fill in the blanks.

(a) Public issues of shares are often announced with attractive prospects of dividend distribution and_____________ which may be exaggerated, if not misleading.

(b) The stock market quotations do not usually reflect the _____________value of existing shares.

(c) SEBI, under SEBI Act, has been made the administrative authority for enforcement of the provisions of the Companies Act with respect to several aspects of _____________

(d) There is need for strengthening the hands of SEBI with more legal and _____________ powers to protect investors' interest in securities market.

(e) Deficiency in corporate governance also affect transparency in financial reporting and accountability of _____________ with respect to their responsibility towards minority shareholders and ....investors.

12.4 CONCEPT OF CORPROATE GOVERNANCE

Corporate governance is another important concept related to inspiring and strengthening investors' confidence by ensuring transparency in functioning and reporting, and accountability and fairness to investors' interests besides respecting the aspirations of multiple stakeholders including that of the society. Let us now understand this concept and its basic features.

Given a narrow interpretation, corporate governance may be defined as the accountability of senior management towards the shareholders. In a wider sense, however, corporate governance may be said to include the entire network of interactions in the corporate sector and its impact on the society as a whole. In the present day context, the concept of corporate governance hinges on complete transparency, integrity and accountability of the corporate management with a focus on public interest and investor protection. It connotes a blend of rules, regulations, laws and voluntary practices that enable companies to attract financial and human capital, perform efficiently and, thereby, maximize long term value for the shareholders besides respecting the aspirations of multiple stakeholders including that of the society. Thus, it refers to a system by which companies are directed and controlled keeping in view the long term interests of its stakeholders, viz., shareholders, employees, creditors, customers and society.

Corporate governance was officially taken up as in issue in UK in 1990 as a result of a series of business scandals in the late 80's which included public outrage at the plundering of pension funds of Maxwell Communication Group, at the failure of auditors to expose the impending bankruptcy of Bank of Credit and Commerce International, and at the apparently underserved high pay raises of senior business executives. A Committee headed by Sir Adrian Cadbury was appointed in 1991 to recommend a code of good corporate governance and suggest ways and means to ensure its compliance. The Cadbury Committee report mainly dealt with aspects of financial transparency and the related role of directors and auditors. In USA, the Blue Ribbon Committee on Corporate Governance also reported on similar lines.

The code of corporate governance cannot be identical for all countries. However, the basic principles related with the concept of good governance, according to Sir Adrian, are more or less valid for business corporations in every country. These include clear responsibilities, a precise distinction between direction and management, check and balances in the governance structure, effective financial control and transparency, accountability and fairness to all stakeholders, and social and environmental concern.

12.5 BROAD OBJECTIVES OF CORPROATE GOVERNANCE

Analytically, the objectives of corporate governance may be considered from the private and public perspectives. From the perspective of a company, corporate governance is expected to be concerned with maximising value subject to the company's financial, legal, and contractual obligations. The focus is on the responsibility of the board of directors to balance the interest of shareholders with those of the other stakeholders in order to achieve long-term sustained value for the company. From the public perspective, corporate governance should involve nurturing enterprises while ensuring accountability in the exercise of power and patronage of firms. The role of public policy should be to provide incentives and enforce discipline to minimize divergence between private and social returns and to protect the interest of all stakeholders.

According to the Birla Committee on Corporate Governance, a committee appointed by SEBI and headed by Kumar Mangalam Birla, the fundamental objective of corporate governance is the enhancement of long-term shareholder value while protecting, at the same time, the interest of other stakeholders.

Generally speaking, therefore, the broad objectives of corporate governance are: (a) compliance with laws, (b) good performance, and (c) accountability with a view to enhance long term shareholders' value by ensuring company's commitment to higher growth and profits while protecting interests of other stakeholders.

12.6 ACCOUNTABILITY AS THE KEY TO GOOD CORPORATE GOVERNANCE

There are three vital elements of corporate governance, viz., accountability, transparency and equality of treatment of all stakeholders. Of these, accountability is recognised as the key element of good corporate governance. Kumar Mangalam Birla Committee on corporate governance had also observed that, "A system of good corporate governance promotes relationships of accountability between the principal actors of sound financial reporting – the board, the management and the auditor. It holds the management accountable to the broad and the board accountable to the shareholders".

Non-conformity with standards of financial reporting and absence of transparent reporting practices often result in unscrupulous management of companies, and investors suffer losses mainly due to lack of accountability on part of directors and management. Hence, the board of directors has a pivotal role in any system of corporate governance. While the board directs and controls management (chief executive, executive directors and key managers), the directors are jointly and severally accountable to all the stakeholders. The board may be required periodically to report on the activities and progress of the company in a transparent way to the all stakeholders.

The tools commonly prescribed for ensuring accountability are summarized as follows.

1 The board is balanced as regards the representation of sufficient number of non-executive and independent directors who will take care of the interest of all stakeholders.

2 The board adopts transparent procedures and practices and keeps the shareholders duly informed of the relevant developments impacting the company.

3 A proper internal control system is put in place and the same is reviewed from time to time. It facilitates the effectiveness and efficiency of operations, and ensures the reliability of reporting.

4 There is periodic monitoring through internal audit which may ensure the institutionalizing of the financial and operating control system in a company.

5 There exists a sound system of periodic financial reporting which ensures adequate disclosures and transparency in governance.

6 There is an audit committee of independent directors. It is the most vital link in the establishment of a system of accountability to promote good corporate governance.

12.7 REQUISITES OF GOOD CORPORATE GOVERNANCE

For good corporate governance we expect management to provide appropriate direction, achieve goals set for the organisation, provide transparency, remain accountable for their actions, and protect the interests of all stakeholders. This requires, as underlined by experts and various committees on corporate governance, the system to ensure the following.

1 There is a properly structured broad, capable of taking independent and objective decisions, put at the helm of affairs.

2 The broad has adequate number of non-executive and independent directors.

3 The board is aware of the concerns of all stakeholders and has an effective machinery to subserve their concerns.

4 The board takes well-informed and well-considered decisions and adopts transparent procedures and practices.

5 There exists a proper system consisting of clearly and adequately defined roles, authority and responsibility of the chief executive, executive directors and managerial personnel in key positions.

6 There is a proper system for guiding, monitoring, reporting and control. Overall, the responsibility of the board of directors is that of guiding the management and overseeing the operations. The board is expected to ensure that the company has necessary information, control and audit systems in place to guide the top management in meeting the corporate objectives. It is also the board's responsibility to ensure that the management complies with legal and ethical standards in accordance with the provisions of law and the company's own statement of values.

7 The board effectively and regularly monitors the functioning of the management team and the implementation of the key decisions.

8 The board remains in an effective control of company's affairs.

It may be noted that while the most important driver for good corporate governance is the leadership consisting of CEO and the Board within a good framework of corporate laws, the other important players are the regulators and investors whose constant vigilance will force the companies to perform and behave well.

12.8 STEPS TAKEN FOR GOOD GOVERNANCE

As a matter of fact, since the emergence of limited liability form of corporate business organisation, the issues embracing corporate governance assumed a great deal of importance and have been warranting close security. However, the concern for the concept has been raised recently because of the growing level of fall outs in corporate sectors leading to sever injury, not only to the interest of common investors but to the whole economy. The prominence of the concept began with Cadbury Committee Report after facing financial crisis due to business failures in UK. The recommendations of the Cadbury Committee in 1992 and the Greenbury Committee in 1995 were included in a combined code which became part of the London Stock Exchange guidelines. While the emphasis in the Cadbury Committee Report was on audit committee, remuneration committee, directors' training, standards of conduct, financial reporting, etc., the Greenbury Committee recommendations emphasized on interim reporting, directors' responsibility statement, compliance certifications, voting by institutional investors, etc. The Hampel Committee on corporate governance took the concept further and included ideas of growth and shareholders prosperity in its ambit. It was followed by Blue Ribbon Committee on corporate governance in USA. The debate on corporate governance was on in many other parts of the world at the same time, and India has not been far behind.

In India, right from the beginning, the style of corporate governance has been influenced by the government and the regulatory bodies. The Ministry of Finance appointed a three members committee in mid 1990 to study the current state of corporate governance in the country. The committee observed that the corporate governance in India was driven by collective conscience rather than such things as the demands and interests of stakeholders or the pull and push of market forces. However, somewhere in 1998, the Confederation of Indian Industry (CII) published a Code on Desirable Corporate Governance , which included recommendations for management and supervisory categories of board, consolidation of accounts, limited directorships, inclusion of non-executive directors with well defined responsibilities, audit committee, disclosure norms etc. to increase accountability and efficiency. Then in May 1999, SEBI appointed Kumar Manglam Birla Committee on Corporate Governance and, based on its recommendations, it directed stock exchanges on 21st February, 2000 to amend the listing agreements and include Clause 49 on corporate governance. This clause broadly covered the following points.

1 Board of Directors and its Composition
2 Audit Committee
3 Remuneration of Directors
4 Board Procedure
5 Management Discussion and Analysis Report
6 Shareholders / Investors Grievances Committee and other shareholders' issues
7 Report on Corporate Governance
8 Certificate of Compliance

Companies like Grasim, HDFC and Infosys Tech took the lead in implementing these recommendations. Global Telesystems appointed Corporate Governance Task Force and publishes its corporate governance report on company's compliance not only with Clause 49 but also with the Blue Ribbon Committee and CII Code.

Later, the Companies (Amendment) Act, 2000 laid down provisions for greater transparency in corporate governance, voting through postal ballot, filing of a secretarial compliance certificate with the concerned Registrar of Companies, insertion of Director's Responsibility Statement in Director's Report, appointment of audit committee, protection of small depositors, and appointment of one director by small shareholders, etc. Subsequently, on 29th October, 2004, SEBI also amended the original Clause 49 and issued a new Clause 49 which all listed companies have to comply with. It lays down higher qualification criteria for independent directors, reduction of gap between two board meetings, more frequent meetings of audit committees, and so on. The details of all these aspects have been discussed in sections to follow.

Check Your Progress B

1 Define corporate governance.

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2 State any four basic principles of good governance as enunciated by Sir Adrian Cadbury.

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3 What are the tools prescribed for ensuring accountability ?

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4 State which of the following statements are True or False

(a) According to Birla Committee on Corporate Governance, the fundamental objective of corporate governance is the enhancement long-term shareholder value while protecting the interests of other stakeholders.

(b) The most important drivers for good corporate governance is the management team consisting of executive directors and key managers.

(c) It is the Board's responsibility to ensure that management complies with legal and ethical standards.

(d) Kumar Manglam Birla Committee on Corporate Governance was appointed in 1999 by the Ministry of Finance.

(e) Code on Desirable Corporate Governance was published by Blue Ribbon Committee in USA.

12.9 CORPORATE GOVERNANCE CODE UNDER CLAUSE 49

Under Clause 49 of the listing agreement as revised in October 2004, SEBI requires companies having a paid up share capital of Rs. 3 crore and above, to comply with the following stipulations which are mandatory.

I Board of Directors

(a) **Composition of the board :** The board of directors of the company is to have an optimum composition of executive and of non-executive directors with not less than 50 per cent of the board members comprising non-executive directors. But where the chairman of the board is a non-executive director, at least one-third of the board should comprise of independent directors, and if he is an executive director, at least half of the board should comprise of independent directors. An independent director means a non-executive director of the company who, apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, subsidiaries and associates, which may affect independence of the director. Also, such a director should not be related to promoters or persons occupying managerial positions, and must not have been an executive of the company in the preceding three years. Further, he is not to have substantial shareholding in the company i.e., owning 2 per cent or more of the block of voting shares. Nominees of institutions that have invested in or lent to the company shall be deemed as independent directors.

(b) **Compensation to non-executive directors :** All fees/ compensation payable to non-executive directors, including independent directors, are to be fixed by the board and must have previous approval of shareholders in the general meeting. The shareholders' resolution is to specify the limits for the maximum number of stock options that can be granted to non-executive and independent directors in any financial year and in aggregate.

(c) **Board procedure :** The board is to meet at least four times a year with a maximum time gap of 3 months between two meetings. The minimum information to be made available to the board is laid down. Further, a director is not to be a member of more than ten committees or act as chairman of more than five committees across all companies in which he is a director. Also, it should be mandatory for every director to inform the company about the committee position he occupies in other companies and notify changes as and when they take place.

(d) **Code of conduct :** The board is to lay down a code of conduct for all board members and senior management of the company, which should be posted on the website of the company. All board members and senior management personnel are to affirm compliance with the code on an annual basis. The Annual Report of the company is to include a declaration to this effect signed by the CEO.

II Audit Committee

(a) **Qualified and independent audit committee :** A qualified and independent audit committee is to be set up, giving the terms of reference, with a minimum of three directors as members, two-thirds of the members being independent directors all members being financially literate and at least one member having financial or accounting management expertise. The Chairman of the

Committee is to be an independent director, who is to be present at Annual General Meeting to answer shareholders' queries. The Company Secretary is to act as secretary to the committee.

(b) **Meetings :** The audit committee should meet at least four times in a year and not more than four months should elapse between the meetings. The quorum is to be either two members or one-third of the members of the committee whichever is greater. But there has to be a minimum of two independent members present.

(c) **Powers** : The powers of audit committee should include powers (i) to investigate any activity within the terms of reference, (ii) to seek information from any employee, (iii) to obtain outside legal or other professional advice, and (iv) to secure attendance of outsiders with relevant expertise, if necessary.

(d) **Role :** The role of the audit committee encompasses (i) oversight of the company's reporting process and disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible; (ii) recommending to the board the appointment, reappointment, or removal or replacement of the statutory auditor and fixation of audit fees; (iii) reviewing with the management, the quarterly and annual financial statements before submission to the board for approval; (iv) reviewing with the management, performance of statutory and internal auditors and adequacy of the internal control systems; (v) reviewing the adequacy of internal audit function and discussion with internal auditors any significant findings and follow up thereon; (vi) reviewing the findings of any internal investigations into matters of suspected fraud or irregularity a failure of internal control systems of a material nature and reporting the matter to the board; (vii) discussion with statutory auditors before the audit commences about the nature and scope of audit as well as post-audit discussion on any area of concern; (viii) to look into the reasons for substantial defaults in the payment to depositors, debenture holders, shareholders (of declared dividend) and creditors; and (ix) reviewing the company's financial and risk management policies

(e) **Review of information** : The audit committee is mandatory required to review the information relating to (i) management discussion and analysis of financial condition and results of operations; (ii) statement of related party transactions; (iii) internal control weaknesses and internal audit report on the same; and (iv) appointment, removal and terms of remuneration of the chief internal auditor.

III Subsidiary Companies

(a) At least one independent director of holding company is to be a member of the board of directors of an unlisted Indian subsidiary company.

(b) The Audit Committee of the holding company shall review the financial statements of the unlisted subsidiary company, in particular, its investments.

(c) The minutes of the board meetings of the unlisted subsidiary company have to be placed at the board meeting of the listed holding company.

IV Disclosure

(a) **Basis of related party transactions :** Basis of related party transactions should be placed periodically before the audit committee along with a statement in summary form of transactions with related parties in the ordinary course of business, and details of material individual transactions with related parties which are not in the normal course of business, or are not on an arm's length basis, together with the management's justification of the same.

(b) **Treatment different from that prescribed in the accounting standard** : Disclosure is required to be made in the financial statements where, in the preparation of statements, the treatment followed has been different from that prescribed in an Accounting Standard, and the management's explanation in the Corporate Governance Report as to why such alternative treatment was believed to be more representative of the true and fair view of the underlying business transaction.

(c) **Risk management and minimization procedures :** Disclosure is to be made by the company to inform board members about the procedures laid down for risk assessment and its minimization.

(d) **Application of funds raised through public, rights issue, etc :** Proceeds from public issues, rights issues and preferential issues are to be disclosed to the Audit Committee with the uses/application of funds according to major categories (capital expenditure, sales marketing costs, working capital, etc.) on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company is to prepare a statement of funds utilized for purposes other than those stated in the offer document / prospectus / notice, and place it before the audit committee for making appropriate recommendations to the board in the matter.

(e) **Remuneration of the directors :** All pecuniary relationship or transactions of the non-executive directors vis-à-vis the company are to be disclosed in the Annual Report. Further, remuneration of directors is to be disclosed in the section on the corporate governance of the Annual Report including all elements of remuneration package of individual directors, details of fixed component and performance linked incentives, service contracts, stock option details, etc. The company is also to publish in the annual report its criteria of making payments to non-executive directors, as well as disclose the number of shares and convertible instruments held by them. Further, the non-executive directors are to disclose their shareholding in the listed company in which they are proposed to be appointed as directors, prior to the appointment.

(f) **Management discussion and analysis report :** A management discussion and analysis report is to form a part of the Annual Report of the company to shareholders. It should include discussion on matters like industry structure and developments, opportunities and threats, segment-wise and product-wise performance, outlook, risks and concerns, internal control systems and their adequacy, material developments in human resources/industrial relations, etc.

(g) **Transactions with senior management's personal interest :** Senior management is to disclose to the board all material, financial and commercial transactions wherein they have personal interest that may have a potential conflict with the company at large.

(h) **Appointment /reappointment of a director :** In case of appointment of a new director or reappointment of a director, the shareholders are to be provided with the information such as brief resume of the director, nature of his expertise in specific functional areas, and names of companies in which the person also holds directorship and membership of committee of the board.

(i) **Details of non-compliance by the company, penalties, strictures** imposed on the company by stock exchange or SEBI or any statutory authority, on any matter related to capital markets.

(j) **Information on website :** Quarterly results and presentations made by the company to analysts are to be put on the company's website, or set in a form so as to enable the stock exchange concerned to put it on its own website.

V Shareholders Investors Grievance Committee

A board committee under the chairmanship of a non-executive director has to be formed to look into the redressal of shareholders and investors' complaints like transfer of shares, non-receipt of annual report, non-receipt of declared dividends, etc.

VI CEO/CFO Certification

CEO i.e., Managing Director or General Manager, and the CFO i.e., the whole-time Finance Director or any other person heading the finance function, are to certify to the board that -

(a) they have reviewed financial statements for the year and that, to the best of their knowledge and belief, these statement do not contain any materially untrue statement or omit any material fact or contain misleading statements, and that the statements present a true and fair view of the company's affairs and are in compliance with the existing accounting standards, applicable laws and guidelines;

(b) to the best of their knowledge and belief, no transactions entered into by the company are fraudulent, illegal or volatile of the company's code of conduct;

(c) they accept responsibility for internal controls and that they have evaluated the effectiveness of the internal control systems, and have disclosed to the auditors and the audit committee, deficiencies in the design or operation of internal controls, if any, and the steps they have taken to rectify the deficiencies;

(d) they have indicated to the auditors and the audit committee about significant changes in internal control and in accounting policies during the year, and also about instances of significant fraud and involvement therein of the management or any employee.

VII Report on Corporate Governance

There is to be separate section on corporate governance in the Annual Report of the company along with a detailed Compliance Report on Corporate Governance. The details of items to be included in this report are as follows:

(a) **Company's philosophy on code of governance.**

(b) **Board of Directors** composition and category, attendance of each director at the board meetings and the last AGM, and the number and dates of board meetings held.

(c) **Audit Committee :** Broad terms of reference, composition, on number of meetings and attendance.

(d) **Remuneration Committee :** Brief description of the terms of reference, composition, meetings and attendance, remuneration policy and details of remuneration to all directors

(e) **Shareholders Investors Grievance Committee :** Functions, composition, name and designation of the compliance officer, meetings and attendance, details of shareholders' complaints received, number not solved, and pending share transfers as on close of the financial year.

(f) **General Body meetings :** Location and time of where last three AGMs held, details of special resolutions put through postal ballot and proposed to be conducted through postal ballot, and procedure for postal ballot.

(g) **Disclosures :** On materially significant related party transactions with its promoters and directors or the management, their subsidiaries or relatives etc. that may have potential conflict with the interests of the company; details of non-compliance by the company; penalties, strictures imposed on the company by the stock exchanges or SEBI or any statutory authority on any matter related to capital markets during the last three years; and the code of conduct for prevention of insider trading.

(h) **Means of Communications :** Half yearly report sent to each household of shareholders, newspaper in which quarterly and annual results published, any website where displayed, presentations made to institutional investors or to the analysts, management discussion and analysis.

(i) **General shareholders information:** Date, time and venue of AGM, financial calendar, date of book closure, dividend payment date, listing on stock exchanges, stock code, market price data and comparison, registrar and share transfer agents, share transfer system, nomination system, distribution of shareholding, plant locations, address for correspondence, etc.

VIII Compliance Certificate

The company is to obtain certificate from either the auditors or the practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in Clause 49 and annex the same with the directors report which forms part of the Annual Report of the company. This certificate is also to be sent to the stock exchanges along with the annual returns filed by the company.

In addition to the above, the companies may also be advised to adopt the non-mandatory requirements relating to (1) chairman's office, (2) remuneration committee, (3) sending of half yearly financial performance report including summary of the significant events to each household of shareholders, and (4) provision of voting through postal ballot on key decisions. If any of these are adopted by the company, the same should also form part of its report on corporate governance.

12.10 PROVISIONS UNDER COMPANIES (AMENDMENT) ACT, 2000

The Companies (Amendment) Act, 2000 was primarily devoted to corporate governance. An outline of the important provisions is given hereunder.

Protection of small depositors : Under Sections 58AA and 58AAA, it is provided that every company which accepts deposits from small investors (those who have deposited upto Rs. 20,000), is to intimate the Company Law Board if any default was made in repayment of any such deposits or interest on deposits. No company can, at any time, accept further deposits from small depositors unless each small depositor, whose deposit had matured, has been paid the amount of deposit and interest accrued thereon. There is penalty stipulated for non-compliance with the above provisions.

Voting through postal ballot : In order to encourage wider participation of shareholders, Section 192A has been introduced to allow them to vote on a particular resolution through postal ballot. Through Rules made by the Central Government, postal ballot has been made mandatory for certain matters. Assent or dissent to each resolution is required to be sent within 30 days.

Au[illegible]ce . Under Section 292A every public company having paid-up capital of R[illegible] crore or more is to constitute an audit committee, consisting of not less than three directors and such number of other directors as the board may decide. Two-thirds of the total number of members of the committee shall be directors other than managing or whole-time directors. The audit committee shall have authority to investigate into any matter relating to items specified or referred to it by the board. In short, the major role of the audit committee will be to oversee the company's financial reporting process and the disclosure of its financial information to ensure that the financial statements are correct, sufficient and credible. Normally, it is also entrusted with the tasks of reviewing adequacy of internal control system and the report of internal and statutory auditors and ensure suitable follow up thereon.

Secretarial Compliance Certificate : Every company having paid-up share capital of Rs. 10 lakh or more but less than Rs. 50 lakh which are not required to appoint a whole-time secretary, are to file with the concerned Registrar of Companies a certificate from a secretary in whole-time practice, in such form as may be prescribed, to the effect that the company has complied with all provisions of the Act. A copy of such certificate is to be attached with the annual report of the board of directors of the company.

Directors Responsibility Statement : The scope of annual report of the board of directors has been enlarged by the Amendment Act. Besides other matters, it is to include a Director Responsibility Statement indicating that (i) in preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures, if any; (ii) the directors had followed appropriate accounting polices consistently so as to give a true and fair view of the state of affairs and profit or loss of the company; (iii) the directors had taken proper and sufficient care for the maintenance of adequate accounting records so as to safeguard the company's asset and to prevent and detect frauds and other irregularities; and (iv) the directors had prepared the annual accounts on a going concern basis.

Director to represent small shareholders : The Amendment Act has laid down that a public company having paid up capital of Rs. 5 crore or more and one thousand or more small shareholders, may appoint at least one director elected by small shareholders (holding shares of nominal value of Rs. 20,000 or less) on its board.

Check Your Progress C

1 What do you mean by an independent director ?

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2 What are the major aspects that CEO and CFO have to certify ?

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3 Explain the rules regarding disclosure of the basis of party related transactions.

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4 Why has voting through postal ballot been introduced ? Is it Mandatory?

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12.11 RENEWED CHALLENGES

In December 2004, the Government of India constituted a committee of experts under the chairmanship of Dr. J. J. Irani, Director of Tata Sons Ltd., for a comprehensive revision of the Companies Act. The objective was to make it simple, amenable to modern technology and, in general, to make regulations easy to observe, prompt in execution, and conform to the modern concept of corporate governance. The Committee submitted its report in May 2005. Some controversial issues that the Irani Committee considered and a few more are outlined below. These constitute the renewed challenges of corporate governance.

Pyramidal structure : Corporate houses generally control diversified business activities through a complex structure of holding companies. A holding company may have a number of subsidiary companies, each of which can be a holding company for another set of subsidiaries. This line can go on to any level forming virtually a pyramidal structure. This leads to corporate abuses with promoters controlling all group companies with small investment, indulge in undercover deals and escape legitimate regulation in the shareholders' interest.

A concept paper had been circulated which sought to do away with the pyramidal structure by suggesting that a subsidiary should not be allowed to act as holding company to other subsidiaries. However, the corporate houses wanted the existing structure to continue, and after deliberations on the issue, the Irani Committee also felt that pyramiding was essential, particularly when Indian companies were going abroad to enlarge business operations. Limiting subsidiary companies to one level, according to the Committee, would definitely inconvenience the corporates and, in some cases, would be a disadvantage in the international context of business. It observed that in order to avoid misuse of the facility there should be a stricter control on the activities of subsidiaries imposed through self-regulation and transparency. In Committee's opinion, doing away with the pyramidal structure would be akin to throwing the baby out with the bath water.

Independent directors as members of the board : The role of the board of directors in corporate governance has been widely recognized in India, and the prevailing view is that there should be an optimum combination of executive and non-executive (independent) directors on the board of every public limited company. As per SEBI, the listed companies with paid-up share capital of Rs. 3 crore and above are required to have not less than fifty percent of the board of directors comprising of independent directors where the chairman and managing director are one and the same person and, if the chairman is a non-executive director, at least one-third of the members of the board should comprise of independent directors. However, the Irani Panel has recommended that a minimum of one-third of the board should be independent directors and the audit committee should have a majority of independent directors. These directors should be empowered not only to call for explanations from the statutory auditors, but each of them should have the authority to call an independent opinion on any matter concerning the company. The above stipulation, according to the Panel, would ensure that independent directors really acted in the Interest of all shareholders and not for the majority shareholders only. The Panel has also suggested rules to be framed laying down duties of independent directors to ensure that they are truly independent and are not, in any significant manner, concerned with the fortunes of the company, on the board of which he or she is appointed as an independent director. Thus, the Irani Committee's recommendation of having one-third of the directors as independent directors could be regarded as a practical solution to the scramble by companies to fill up the positions of independent directors.

Reducing intervention in companies by government / regulatory authority : The Irani Panel is in favour of reducing government intervention and ending multiple jurisdiction of regulators with respect to company affairs. Their contention is that, with greater transparency and self-regulation, control over companies must rest in the hands of shareholders and references to government and regulators should be reduced to an absolute minimum to ensure smooth functioning of the corporates. In such a set up, the role of independent directors also becomes extremely important. The Panel has also recommended reduction of judicial intervention in case of minor technical offences. They have suggested an inhouse structure for dealing with cases of technical default involving imposition of monetary penalties under the Act, with powers to impose penalties for offences other than those punishable with imprisonment, or imprisonment and fine. This is expected to substantially reduce judicial intervention in case of company law offences.

Disclosure and dissemination of information : Technology has no doubt played an important role in the capital market on two fronts, viz., screen-based trading and dematerialisation. However, these are essentially process-based changes and have little impact on the quality of disclosure and dissemination of information which remains poor due to bad formats. Not only that, in matter of dissemination of information, most stock exchanges entrusted with the responsibility have not fully lived upto the challenge and, reportedly, many stock exchanges do not have any system of information management. Even the centralised corporate information effort through SEBI's website (EDIFAR), launched two year age, is found to be extremely unfriendly, and several types of information are missing or are outdated. The listed companies also do not file all the mandated information and, what is filed is not archived properly. As a result, when a listed company makes a follow-on offering, the disclosures at the time of issue are huge as most of it had not been made public in course of regular disclosures. At another level, information is highly lacking in certain key aspects, such as changes in the names of the companies, and indictments by regulators of companies, intermediaries and individuals.

Certification by CEO and CFO : Clause 49 requires CEOs and CFOs to certify that they have internal controls in place but it does not specify the areas of controls. It also fails to clarify whether control means control over financial reporting processor or it extends to the whole gamet of how companies manage their business risks. There is no guidance even from SEBI as to what it covers. According to Ameet Parikh of Axis Risk Consultancy Services, most corporates are adopting the Sarbanes Oxley Act of the US as guidelines for implementing this provision knowing full well that the focus in SOX Act is purely on financial processes. He also stated that Clause 49 is more in line with the regulation in force in UK and South Africa where the controls are restricted to just financial reporting as in the US. But, in the spirit of Clause 49, it is felt that the controls should go beyond just financial reporting and cover a wider spectrum so as to do justice to the concept of corporate governance.

What the above new set of issues have shown is that the responsibility of corporate governance needs to be tackled at various levels within the company and, if corporate governance has to succeed in India, it has to be accepted as a moral issue based on the foundations of value and ethics. The former SEBI Chairman, G N Bajpai had said, 'Good corporate governance must fulfil the primary objective of coming into being of a corporate i.e., through wealth creation, through wealth management and through appropriately sharing the wealth with all the stakeholders. This can be facilitated only if corporate governance moves from mere form to substance . Ethics will have to play a prominent role in corporate governance and instruments must be available to evaluate quality of governance so that market is able to reward corporate governance practices".

12.12 LET US SUM UP

Individual investors need to be protected on account of their ignorance, lack of information and various lacunae and flaws in the capital market. It is observed that (i) public issues of securities are often announced with exaggerated and misleading prospects, (ii) financial statements of existing companies issuing shares often lack transparency and detailed information, (iii) rise in security price which attract investors may be the result of manipulations, (iv) there are deficiencies in corporate governance, and (v) delay in redressal of shareholders' grievances is a common practice. Hence, to protect investors' interest against such practices, a number of provisions have been made in the Companies Act, Securities Contracts (Regulation) Act and SEBI Act. Of late, SEBI has played a dominant role in taking care of their interests by issuing SEBI (Disclosure and Investor Protection) Guidelines, taking steps to educate the investors through various programmes, and helping in the redressal of their grievances on matters related to public issues and capital market operations. Ensuring good corporate governance is another step in that direction.

Narrowly interpreted, corporate governance is defined as the accountability of senior management team towards the shareholders. In a wider sense, it connotes a blend of rules, regulations, laws and voluntary practices that enable companies to attract financial and human capital to perform efficiently and thereby maximize long-term value for the shareholders besides respecting the aspirations of multiple shareholders including that of the society. Thus, it hinges on complete transparency, integrity and accountability of the board of directors with a focus on public interest and investor protection. The broad objectives of corporate governance, therefore, are : (a) compliance with laws, (b) good performance, and (c) accountability with a view to enhance long-term shareholder value by ensuring company's commitment to higher growth and profits while protecting the interests of other stakeholders.

The guidelines of corporate governance vary according to the corporate environment in countries, but accountability is central to any model. The management and the auditors have a pivotal role in any system of corporate governance. The tools commonly prescribed for ensuring accountability are : (1) balanced board of the directors, (2) transparent procedures and practices, (3) proper internal control system, (4) periodic monitoring through internal audits, (5) adequate disclosures in financial reporting, and (6) and audit committee of independent directors.

The requisites of good corporate governance consist of (1) properly structured board with a number of non-executive independent directors capable of taking objective decisions, (2) awareness of the concerns of all stakeholders, (3) a system with well defined authority and responsibility (4) a proper system for guiding, monitoring, reporting and control; (5) effective and regular monitoring of the functioning of management team, and (6) the board remaining in effective control of company's affairs.

The prominence of the concept of corporate governance began with Cadbury Committee Report in 1992 followed by Greenbury Committee Report in 1995 in UK and later the Blue Ribbon Committee Report in USA while debate was on in many other parts of the world. In India, it began with a three members committee appointed by the Ministry of Finance in 1990, but with little follow up action. In 1998, CII published a Code on Desirable Corporate Governance. In 1999, SEBI appointed Kumar Manglam Committee and, based on its recommendation, it directed stock exchanges, in February 2000, to include Clause 49 on corporate governance in their listing agreements. Later, the Companies (Amendment) Act, 2000 made certain provisions for greater transparency in corporate governance. Subsequently, on October 29, 2004, SEBI also made certain amendments in Clause 49 for improving its effectiveness.

Under Clause 49 of the listing agreement, as revised by SEBI in October 2004, companies having a paid up share capital of Rs. 3 crore and above, are required to comply with provisions relating to (1) composition of the board of directors, their meetings and the code of conduct for its members, (2) setting up a qualified and independent audit committee, its powers, role, etc., (3) governance of enlisted subsidiary companies, (4) disclosures to be made by management on the basis of related party transactions, deviations from accounting standards, risk management procedures, use of proceeds from public issues, remuneration of directors, management discussion and analysis report, etc., (5) Shareholders / Investors Grievances' Committee for redressal of complaints, (6) CEO / CFO certification of specified matters, (7) a detailed compliance report on corporate governance (to be included in the Annual Report) and quarterly compliance reports to be submitted to stock exchanges, and (8) certificate regarding compliance of the conditions of corporate governance as stipulated in Clause 49 to be annexed with the directors' report.

The Companies (Amendment) Act, 2000 was primarily devoted to corporate governance. Its important provisions related to (a) protection of small depositors, (b) voting through postal ballot, (3) audit committee to be constituted to oversee financial reporting process and disclosure of financial information, (4) Secretarial Compliance Certificate in prescribed from to be filed with the concerned ROC and copy to be attached with Annual Report of the board in case of companies that are not required to appoint a whole time company secretary, (5) Director's Responsibility Statement to be included in the board's report, and (6) appointment of a director elected by small shareholders.

In December 2004, Government of India appointed Irani Committee for a comprehensive revision of the Companies Act. A few issues raised by the Committee in its report constitute the renewed challenges of corporate governance which relate to

(a) pyramidal structure of corporate houses, (b) independent directors as members of the board, (c) reducing intervention in company affairs by government / regulatory authority, (d) disclosure and dissemination of information, and (e) Certification by CFO and CEO. These new set of issues indicate that the responsibility of corporate governance lies within the company at various levels and it has to be accepted as a moral issue.

12.13 KEY WORDS

Corporate governance : A blend of rules, regulations and voluntary practices that enable companies to perform efficiently and thereby maximize long-term value for the shareholders besides respecting the multiple stakeholders including that of the society.

Independent Director : A non-executive director of the company who, apart from receiving director's remuneration, does not have any material primary interest or relationship with the company, its promoters, subsidiaries and associates.

Pyramidal Structure : It refers to a complex structure of holding companies whereby a holding company may have a number of subsidiary companies, each of which may be a holding company for another set of subsidiaries.

Related Party Transaction : Transactions with company's promoters, directors or the management or their subsidiaries or relatives etc.

12.14 ANSWERS TO CHECK YOUR PROGRES

A 3 (a) growth (b) intrinsic (c) capital issues (d) judicial (e) directors, small

B 4 (a) True (b) False (c) True (d) False (e) False

12.15 TERMINAL QUESTIONS

1 Discuss why investors' protection has become a matter of serious concern in recent times and outline the provisions of various laws and the role of SEBI in this regard.
2 Explain briefly the concept of corporate governance, and enumerate its broad objectives.
3 State the requisites of good corporate governance, and explain as to why accountability is regarded as the key to success in corporate governance.
4 Describe briefly the evolution of the concept of corporate governance and outline the various measures adopted in India to ensure good corporate governance.
5 State, with reasons, the major provisions of the Companies (Amendment) Act, 2000 aimed at enhancing the quality of corporate governance.
6 Outline the major requirements under Clause 49 of listing agreement under SEBI regulations.

7 State the composition of audit committee as per rules, and discuss its role in corporate governance.

8 Look at the corporate governance report as given in the Annual Report of a company, and outline the requirements of such report and its importance for the shareholders.

9 Discuss the main issues comprising renewed challenges of corporate governance with special reference to the recommendations of the Irani Panel.

10 Explain the following in the context of corporate governance.

(a) Secretarial Compliance Certificate

(b) CEO/ CFO Certification

(c) Management Discussion and Analysis

(d) Directors Responsibility Statement

> **Note :** These questions will help you to understand the unit better. Try to write answers for them, but do not submit your answers to the university for assessment. These are for your practice only.

SOME USEFUL BOOKS

Francis Cheunilam, Business Environment : Text and Cases, Himalaya Publishing House, Mumbai.

Ghosh, P. K. and Kapoor, G. K., Business and Policy and Environment, Sultan Chand & Sons, New Delhi.

Gopal, K., "Emerging Trends in Corporate Governance" in Indian Management, October 1998.

Machiraju, H. R., Indian Financial System, Vikas Publishing House, New Delhi.

Misra, S. K., Money, Income and Financial Institutions, Pragati Publications, Delhi.

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