Legal tradition on Corporate Governance: A vista for Public Companies in India

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Corporate governance as involving “a set of relationships between a company’s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company or group and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. Effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the firm’s system, which are critical to the proper functioning of the organization and economy as a whole. Poor corporate governance can contribute to the institution failures, which can in turn pose significant public costs and consequences due to their potential impact on any applicable deposit insurance system and the possibility of broader macroeconomic implications, such as contagion risk and impact on payment systems. This has been illustrated in the financial crisis that began in mid-2007. In addition, poor corporate governance can lead markets to lose confidence in the ability of a firm to properly manage its assets and liabilities, including deposits, which could in turn trigger a company run or liquidity crisis. Indeed, in addition to their responsibilities to shareholders, companies also have a responsibility to their depositors and to other recognized stakeholders. The legal and regulatory system in a country determines the formal responsibilities a company has to its shareholders, depositors and other relevant stakeholders. This document will use the phrase “shareholders, depositors and other relevant stakeholders,” while recognizing that banks’ responsibilities in this regard vary across jurisdictions. Supervisors have a keen interest in sound corporate governance as it is an essential element in the safe and sound functioning of a institution and may adversely affect the company’s risk profile if not implemented effectively. Good corporate governance requires appropriate and effective legal, regulatory and institutional foundations. A variety of factors, including the system of business laws, stock exchange rules and accounting standards, can affect market integrity and systemic stability. Such factors are often outside the scope of company supervision. Supervisors are nevertheless encouraged to be aware of legal and institutional impediments to sound corporate governance, and to take steps to foster effective foundations for corporate governance where it is within their legal authority to do so. Where it is not, supervisors may wish to consider supporting legislative or other reforms that would allow them to have a more direct role in promoting or requiring good corporate governance. Moreover, governance weaknesses at banks that play a significant role in the financial system, including systemically important clearing and settlement systems, can result in the transmission of problems across the banking sector. Well-governed banks contribute to the maintenance of an efficient and cost-effective supervisory system. In case of bank, sound corporate governance also contributes to the protection of depositors and may permit the supervisor to place more reliance on the bank's internal processes. In this regard, supervisory experience underscores the importance of having the appropriate levels of accountability and checks and balances within each bank. Moreover, sound corporate governance practices can be helpful where a bank is experiencing problems. In such cases, the supervisor may require substantially more involvement by the bank's board or those responsible for the control functions in seeking solutions and overseeing the implementation of corrective actions.

Objectives of the study

Corporate governance abuses perpetrated by a dominant shareholder pose a difficult regulatory dilemma in that regulatory intervention would often imply a micro-management of routine business decisions. The regulator is forced to confine him to broad proscriptions which leave little room for discretionary action. The main focus of the study under consideration is to stress on regulation in connection with corporate governance in Indian public corporate sector.

Challenges for Corporate Governance

There are unique corporate governance challenges posed where company's ownership structures are unduly complex, lack transparency, or impede appropriate checks and balances. Challenges can also arise when insiders or controlling shareholders exercise inappropriate influences on the firm's activities. The Committee is not suggesting that the existence of controlling shareholders is in and of itself inappropriate; in many markets and for many small firms this is a common ownership pattern. Indeed, controlling shareholders can be beneficial resources for a bank firm. It is nevertheless important that supervisors take steps to ensure that such ownership structures do not impede sound corporate governance. In particular, supervisors should have the ability to assess the fitness and propriety of significant bank owners as well as board members and senior managers. The general principles of sound corporate governance should also be applied to state-owned or state-supported banks, including when such support is temporary. In these cases, government financing or ownership (even if temporary) may raise new governance challenges. Although government financing or ownership of a firm has the potential to alter the strategies and objectives of the bank, such a bank may face many of the same risks associated with weak corporate governance as are faced by firms that are not state-owned or supported. The governance issue in the US or the UK is essentially that of disciplining the management who have ceased to be effectively accountable to the owners. The solution has been to improve the functioning of vital organs of the company like the board of directors. The problem in the Indian corporate sector is that of disciplining the dominant shareholder and protecting the minority shareholders. A board which is accountable to the owners would only be one which is accountable to the dominant shareholder; it would not make the governance problem any easier to solve. Clearly, the problem of corporate governance abuses by the dominant shareholder can be solved only by forces outside the company itself.

Corporate Governance (CG) of Banks

Nowhere is proper corporate governance more crucial than for banks and financial institutions. Given the pivotal role that banks play in the financial and economic system of a developing country, bank failure owing to unethical or incompetent management action poses a threat not just to the shareholders but to the depositing public and the economy at large. Two main features set banks apart from other business – the level of opaqueness in their functioning and the relatively greater role of government and regulatory agencies in their activities. The opaqueness in banking creates considerable information asymmetries between the "insiders" – management – and "outsiders" – owners and creditors. The very nature of the business makes it extremely easy and tempting for management to alter the risk profile of banks as well as siphon off funds. It is, therefore, much more difficult for the owners to effectively monitor the functioning of bank management. Existence of explicit or implicit

deposit insurance also reduces the interest of depositors in monitoring bank management activities. It is partly for these reasons that prudential norms of banking and close monitoring by the central bank of commercial bank activities are essential for smooth functioning of the banking sector. The reforms have marked a shift from hands-on government control interference to market forces as the dominant paradigm of corporate governance in Indian banks. Competition has been encouraged with the issue of licenses to new private banks and more power and flexibility have been granted to the bank management both in directing credit as well as in setting prices. The RBI has moved to a model of governance by prudential norms rather from that of direct interference, even allowing debate about appropriateness of specific regulations among banks. Along with these changes, market
institutions have been strengthened by government with attempts to infuse greater transparency and liquidity in markets for government securities and other asset markets. This market orientation of governance disciplining in banking has been accompanied by a stronger disclosure norms and stress on periodic RBI surveillance. From 1994, the Board for Financial Supervision (BFS) inspects and monitors banks using the "CAMELS" (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and controls) approach. Audit committees in banks have been stipulated since 1995. Greater independence of public sector banks has also been a key feature of the reforms. Nominee directors – from government as well as RBIs – are being gradually phased off with a stress on Boards being more often elected than "appointed from above". Rules like non-lending to companies who have one or more of a bank's directors on their boards are being softened or removed altogether, thus allowing for "related party" transactions for banks. The need for professional advice in the election of executive directors is increasingly realized. As for old private banks, concentrated ownership remains a widespread characteristic, limiting the possibilities of professional excellence and opening the possibility of misdirecting credit. Corporate governance in co-operative banks and NBFCs perhaps need the greatest attention from regulators. Rural co-operative banks are frequently run by politically powerful families as their personal fiefdoms with little professional involvement and considerable channeling of credit to family businesses. It is generally believed that the "new" private banks have better and more professional corporate governance systems in place. However, the recent collapse of the Global Trust Bank has seriously challenged that view and spurred serious thinking on the topic.

India's legal tradition on CG

In order to understand the process and implications of recent regulatory changes in India's corporate governance regime, it is important to have a general overview of India's legal tradition and its current regulation of public companies. This section begins by presenting an overview of India's legal tradition, and follows by outlining the basic corporate law and regulatory framework applicable to public companies in India. It also addresses the role of the government institutions responsible for developing and enforcing Indian corporate law, as well as the role of the judiciary in advancing corporate law.

India's Legal Culture

Indian corporate law continued to emulate English law even after India achieved independence in 1947**.** The Bhabha Committee, whose recommendations ultimately formed the basis for the Companies Act, 1956, was convened partly in response to the report of the United Kingdom's Cohen Committee, which recommended far-reaching changes to the English Companies Act, 1929. Further, the Companies Act drew inspiration from the English model with regard to much more than simple timing. The influence of English company law on the Indian Companies Act, 1956**,** was so prevalent that one Indian committee, convened the following year to assess the success of the new Companies Act and recommend any necessary amendments, saw fit to specifically justify the ways in which they had deviated from the British model. Despite India's common law tradition, "many of its laws were in fact codified during British rule. This was then overlaid with further legislation when, in post-independence India, the government implemented a socialist reform agenda in encompassing all areas of commercial activity, including corporate finance. From 1947 to 1991**,** the government's policies included heavy regulation of public companies; including significant government involvement in public equity offerings that lead to legal measures that "established a tightly-controlled regime covering almost all aspects of corporate management." Thus, much of the post-liberalization period involved dismantling or amending the socialist codification process, and establishing new institutions, such as SEBI**,** to oversee increasingly privatized capital markets.

The Companies Act 1956

The Companies Act, as codified in 1956 and amended thereafter, provides the general legal framework for companies in India, governing the incorporation, functioning, and winding up of Indian companies. All registered companies in India, whether public or private, are governed by the Companies Act. 84 Voluminous and containing hundreds of sections, the Companies Act draws heavily from the U.K. Companies Act of 1948. The regulatory framework governing corporate boards is set forth in Sections 252 to 269 of the Companies Act. The corporate governance principles in the Companies Act, particularly with respect to listed companies, are limited. For example, similar to the corporate law of most U.S. states, the Companies Act does not address specific corporate governance measures such as composition and independence of a company's directors, or the minimum qualifications required to become a director, though it does include some provisions dealing with management and administration of companies. Similarly, the Companies Act of 1956 offers little in the way of investor protection, focusing primarily on cases of oppression and mismanagement. As discussed in Part II.B.4 below, these provisions have provided little protection to shareholders. There is also minimal focus on transparency or disclosure. For example, Indian companies whose shares are not traded on any Indian stock exchange are not required to prepare or distribute quarterly and interim reports to shareholders. In recent years, there have been a number of attempts by the Ministry of Company Affairs (MCA) to amend the Companies Act to improve corporate governance and to modernize India's company law. However, the major amendments to the Act are still pending.

The Legal Authorizes: SEBI and the MCA

Public companies in India face a fragmented regulatory structure. The Companies Act is administered by the MCA and is currently enforced by the Company Law Board (CLB). The MCA, SEBI, and the stock exchanges share jurisdiction over listed companies, with the MCA being the primary government body charged with administering the Companies Act of 1956, while SEBI has served as the securities market regulator since 1992. In connection with India's economic liberalization and the move toward further development of India's capital markets, the central government established regulatory control over the stock markets through the formation of the SEBI which was originally established in 1988 as an advisory body, was granted authority to regulate the securities market under the Securities and Exchange Board of India Act of 1992 (SEBI Act). Through the passage of this Act, Parliament established SEBI as an independent statutory authority, but required it to submit annual reports to the legislature. SEBI was envisioned to serve as a "market oriented independent entity to regulate the securities market" akin to the role of the Securities and Exchange Commission (SEC) in the United States. In fact, the stated purpose of the agency is "to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market." The realm of SEBI's statutory authority has long been the subject of heated debate. Some have argued that "it may be stated that the SEBI Act of 1992 was mostly a list of responsibilities of the regulator and was devoid of reasonable statutory backing for discharging the responsibilities. The primary tasks with which SEBI has been charged include "regulating the business in stock exchanges and any other securities markets. However, SEBI's authority for carrying out these tasks has not always been clear. For example, when Indian financial markets experienced massive share price rigging frauds in the early 1990s, SEBI was found not to have sufficient statutory power to carry out a full investigation of the frauds. Accordingly, the SEBI Act was amended in order to grant it sufficient powers with respect to inspection, investigation, and enforcement, in line with the powers granted to the SEC in the United States. One of the most contentious aspects of SEBI's power is its rulemaking authority. As mentioned, SEBI has made significant amendments to the Listing 'Agreement to greatly increase the responsibilities of listed companies. However, some have disputed that SEBI was ever granted the authority to impose additional governance rules in this fashion. In the United States, for example, the SEC can point to the Sarbanes-Oxley Act as specifically conferring upon it the authority to prescribe rules to implement the legislation. Since SEBI's creation in 1992, tensions have arisen between SEBI and the MCA. The conflicts between SEBI and the MCA stem in part from the reality that many of the regulatory responsibilities created by the various pieces of relevant legislation are exercised concurrently by multiple regulatory agencies. This overlap results from the charges of the agencies themselves, as well as from issues such as the expansion of SEBI's powers. Under the Companies Act, MCA is responsible for regulating all registered companies.' However, under the SEBI Act, all listed companies fall under the authority of SEBI as well. It should be noted that SEBI itself disputes the existence of any regulatory overlap. However, this assessment stands at odds with the record of disagreement between the two agencies concerning the respective responsibilities of each regulatory body.

The Role of the Judiciary in Development of Corporate Law

The primary reason behind the lack of development of corporate governance standards through the judiciary is the failure of the Indian judicial system to effectively resolve corporate disputes. India's judicial process has long been the subject of criticism. Indian courts have developed extensive case law interpreting and applying the provisions of the Companies Act, these judicial judgments have not radically altered the state of corporate governance in India as Clause 49 has."' In fact, some even argue that the lack of judicial action has meant that "India seems to have moved away from the common law tradition of changing the law on a case-by-case basis and toward the tradition of detailed rule-making backed by public enforcement mechanisms, which is usually associated with the civil law countries." According to a vocal critic of the Indian legal system, the judicial process involves countless delays, and when decisions are finally rendered by courts, they are often ignored. "The defining feature of the Indian court system is the staggering delays involved in resolving a case by trial, which typically would take up to 20 years." Given the significant delays in bringing a suit, there is little incentive for shareholders to advocate for their rights through the courts. With respect to enforcing the Companies Act, the NCLT's powers are largely the same as those of the CLB; in fact, many of the amendments given effect by the 2002 Act literally serve only to replace the term "Company Law Board" with the term "Tribunal." Among its other powers, the NCLT has the authority to provide relief in cases of oppression and mismanagement, remove management, direct a special audit, inspect the company's accounts, and impose fines for certain violations of the Companies Act. However, recent data indicate that these abilities are seldom used. One of the most significant changes of the 2002 Act is to provide for a separate appellate body specifically convened to hear appeals from the rulings of the NCLT. The purpose of this amendment was in part to lift a burden from the various high courts. Given the mutually compounding problems that arise when a grossly understaffed judiciary is asked to handle a massive caseload, it becomes readily apparent why a separate Company Law Tribunal with its own counterpart appellate body was needed. Although the rulings of the Appellate Tribunal are still appealable to the Supreme Court of India under the new enforcement scheme, the availability of a separate appellate body specifically tasked with handling appeals from the NCLT's rulings was intended to prevent the tremendous logjam of proceedings previously seen in the various high courts.

Conclusion

The presence of an effective corporate governance system, within an individual company or group and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. Effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and economy as a whole. In recent years, there have been a number of attempts by the Ministry of Company Affairs (MCA) (previously the Department of Company Affairs within the Ministry of Finance) to amend the Companies Act to improve corporate governance and to modernize India's company law. However, the major amendments to the Act are still pending.

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