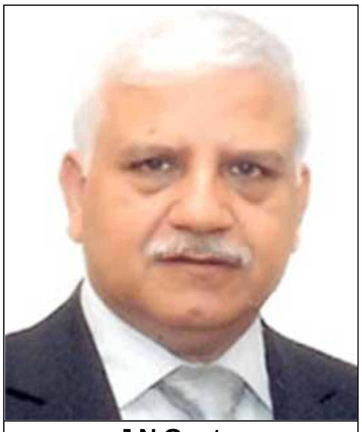
Corporate Governance through Listing Agreement and Companies Act - The Letter and the Spirit



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Analysts, Regulators, Academicians, Practitioners and Investors are almost in agreement that largely the cause for Financial crisis of 2008, rests with poor corporate governance. Lax standards and poor oversight are responsible in equal measures. Post crisis, globally there is a renewed thrust to set it correct at a fast pace, to set right what grossly went wrong. We in India, are not behind. Last 8 years have seen slew of measures both by government and the securities market regulator viz. Securities and Exchange Board of India (SEBI). The biggest of this leg of reforms was the new Companies Act, 2013, which laid a much greater emphasis on Corporate Governance. Additionally, SEBI through its LODR Regulations and through mandates like the compulsory voting by the Mutual Funds at shareholders meetings ,has done a great deal to improve the corporate governance standards in the country. Further, initiatives taken by other authorities like the IRDA through the Stewardship Code are reflective of the Investors concern towards good governance.

As it stands today, after years of evolution, the statutory framework in India related to corporate governance, consists of a comprehensive set of regulations which, by and large, are in consonance with the best practices in the world. In some areas, in fact, we have surpassed the global standards. For instance, in the case of mandatory disclosure by companies of the CEO pay-out ratio, there still isn't a consensus in countries like the USA and UK.

The question that is to be asked is the work over? Answer is a big NO. Because, merely framing law is not enough. All this may look great on paper but what about implementation. When one looks at the reality, it becomes very clear that job is far from over and it may not be even half done.

We explore in this article a few issues, analyse ground level situation and we find that it is not the law which is faulty but its implementation. That is why despite one of the best Code in the world, standards of corporate governance are still rather low in the country.

Disclosure & Compliance:

The corporate governance framework currently for the most part comprises of a 'compliance- statement' regime where a mere statement of compliance is meant to serve as evidence of governance safeguards. A perusal of a typical Annual Report of a listed company in India reveals numerous standard text statements meant simply to technically comply with the law without providing any substantial, objective and meaningful disclosures to the investors. And surprisingly, the language and content have become standard content not only for the reporting company over the years but across companies. It appears that it is some sort of religious ritual that the companies perform without any real intent. To illustrate, some of the disclosure, compliance and implementation related issues are discussed below:

Independent Directors

The law requires that a meeting of IDs must be held. How it is complied with; in the form of a mere statement that a separate meeting of independent directors was held. This hardly serves the spirit of the law which is to ensure a forum where the independent directors don't feel any pressure to express their view, discuss and evaluate. Law requires a declaration by the independent directors that they meet the criteria of independence, any declaration without verification and consequent liability doesn't impose any real liability on the independent directors and can hardly be taken as proof of their actual independence. There are numerous cases where the directors are conflicted and do not meet the independence benchmark set in the Companies Act, 2013. Similarly, disclosures related to the board evaluation process only require a statement to the effect that an evaluation was conducted, there is no disclosure on substance of the discussions and outcome. Proof that these are just ritual, is found if one looks at remuneration in promoter driven companies where one finds that Independent Directors(IDs), part of Nomination and Remuneration Committee(NRC), year after year value their own performance miniscule compared to promoter and reward lavish commissions to promoters and allowing only peanuts to themselves. If one believes that NRC does follow Remuneration Policy and evaluation is objective and fair, then the only conclusion that can be drawn is that these IDs are incompetent. A conclusion that would be contrary to claims made about their past achievements, based on which they were appointed. Therefore, the correct conclusion is that despite all provisions in the law and putting competent and renowned people as IDs, Independence remains a myth. The reason is very simple, Independence is a trait of character, which unfortunately cannot be legislated. The law can only instil fear and ensure compliance. However even there, our achievement is big zero, as not even one ID has been questioned for his conduct. This is not surprising at all, as many IDs are big names including retired bureaucrats, regulators, bankers, retired judges, celebrities and rich people and we are habituated to treat these VIPs with kid gloves for myriad of reasons.

On remuneration of IDs, there are two schools of thought, one argues that since they are paid peanuts, the quality is not good. But the question is who decides their remuneration? They themselves, sitting in NRC dole out lavishly to promoters and decides for themselves what they feel they are worth. The other school of thought has a stronger argument, that many of these IDs are highly paid and the pecuniary interest impacts their independence. Examples are given of retired bureaucrats, regulators and bankers, who after their retirement earn as much as 10 times their annual pay packet just in a year as IDs on boards. This coupled with unwritten perks is too difficult to resist. The lure of money is too appealing and that is why character is what is required to ensure independence.

Dividend Policy

Amid some noise and shareholder complaints about companies not paying dividend despite having surplus cash on their books, SEBI made it mandatory for the top 500 listed firms to have a dividend distribution policy. The idea was to let shareholder know what will be policy and based on performance parameters, shareholders could guestimate likely dividend. It was just to help shareholders plan their cash flow and there was no penalty on companies if declared dividend was not as per policy. It kept final authority with the board. What we see on ground level, almost 100% compliance in letter, but did it meet its objective? We find that what is disclosed by the company is pure technical compliance but spirit of compliance is missing. All possible theoretical explanation is found but nothing which will help investors getting any meaningful information.

Valuation Report

The law mandates (barring a few exemptions) that proposals put to shareholders' approval relating to a 'Scheme of Arrangements' should be accompanied by a Valuation Report, Fairness Opinion and an Audit Committee Recommendation to shareholders. The underlying objective of these provisions was to ensure that a proper valuation is done by an independent valuer, which is scrutinised by an independent third party to ensure that there was no bias in the value derived. And Audit Committee to examine and put their recommendation. What we find at ground, almost perfect compliance. The proposal goes through all the steps in a manner of perfect military drill, with clinical precision. But is there any real information for shareholders? Obviously not. on the other hand, the entire process is a benchmark and can be showcased reflecting bonhomie and unity of thought between all concerned. Not only that, these players (Valuers, fairness opinion giver, Audit Committee and the Board) set a standard on efficiency, as within minutes of valuation report being handed over, fairness opinion is given, Audit committee ever eager to approve, approves the same within minutes and finally board approves it. All it takes is few hours, such coordination and smooth flow is not even seen in an Olympic Relay Race. And no one in the chain ever questions the finding as if the findings are gospel truth. It is not only the process which is gamed, the valuation report most of the times is not worth the paper it is written on. All that one requires to give an acceptable valuation report is knowledge of internet, google chrome or any other browser, reasonable knowledge of English, command over copy and paste, formatting skills. With this almost 99% report can be made in less than an hour. What one needs to finalise the report is some magical trick, to give exchange ratio in case of merger or demerger. As it is really a magic to find ratio without giving value to businesses. Almost all the valuation reports would fail to clear the benchmark of reasonability as far as disclosure parameters and explanation of rationale is concerned.

Annual General Meeting

E-voting has an unintended consequence, it has reduced General meetings of shareholders a ritual without any impact. As E Voting starts and ends before a General Meeting starts, the outcome of resolutions that are to be taken up for discussions is already decided, discussions in AGM no longer influence or impact shareholders view/ vote. No change or amendment in resolutions can be made, even if there is genuine mistake, shareholders amendments cannot be taken into account. Therefore, AGMs have become a ritual which one has to perform regardless of its utility. Did law intend it? Law wanted increased participation but did not envisage this outcome. No one has bothered to solve this issue. Obviously if AGMs become meaningful and interaction is possible and the interaction at AGM can be a tool to influence voting process, *status quo* is a preferred state to be in.

Should India revert to previous regime with no E Voting? Obviously not.

There are far too many benefits of E-Voting that are not easy to be ignored. It has increased participation by investors and made it cost and time effective. E voting, coupled with regulatory dictates, is making an impact and investors are seeing a big positive out of their participation. It is probably first time that Indian investors have tasted power of their votes on corporate governance.

"E-Voting", by one single stroke of legislation made cost of participation almost nil and made casting of vote easy. In true sense, it democratised participation by shareholders.

Arrival of E-Voting for shareholders in Indian companies marks a beginning of an era where shareholders have a voice, which will be effective and can make positive impact on the governance of companies.

Should we live with lacuna or change it? No demand has been made to change the law? Are stakeholders happy or it is the attitude of indifference?

This can be solved in no time, if the rules were to be amended and were to state that the e-voting shall commence 48 hours after conclusion of AGM and shall remain open for three days, all the current disadvantage will vanish and AGMs will once again become meaningful.

Nomination of directors

It is a thought process that a director for election must be proposed by a shareholder and to avoid frivolous candidates a deposit of money was made mandatory. The new law requires director nomination to be done by NRC, where shareholders are not involved. The question arises what is the need for a shareholders' proposal in case candidate is nominated by NRC? Why an unconnected shareholder nominates what has been finalised by NRC? And why deposit must be taken from candidate nominated by NRC? Do we think that even those candidates could be non-serious and frivolous variety? This indicates that the law has not been made in harmonious way. Proposals for appointment of directors nominated by NRC must not require proposals from shareholders and no deposit should be required.

Alternate directors

There is a need to relook at the concept of alternate directors as a whole. Given the technological advancement and that the Companies Act, 2013 allows for attendance through video conference, the position of 'Alternate Director' has in effect become infructuous and directors can easily attend the board meetings from any part of the world.

Further, some directors have been observed to be perennially absent with the alternates attending almost all the board meetings.

Women directors

Majority of the companies have not gone beyond the compulsory minimum one woman director on the board of the company. In many cases, women from the promoter family have been appointed on the board to comply with the legal requirement. while only a handful of companies have 3 or more women directors.

While the law provides that an alternate to an Independent Director must be an Independent Director, it has not explicitly provided the same in case of a woman director. Few companies have appointed a male director as an alternate to the only woman director on the board. This is nothing but a mockery of the legislation.

Succession Planning & Time commitment

Succession planning, or the lack of it, is another example where most of the companies have failed investors. Law mandates Special Resolution if appointee to Executive/ Whole Time Director position is above 70 years of age. The intention of the law clearly is that the companies should take steps to ensure a smooth transition and succession planning. It also intended that the Board must give specific reasons for appointing anyone who is above 70 years, so that shareholders may decide taking into account full details. The other idea was that shareholders may consider age and time commitments of the appointee to take a holistic view. Should the same law not apply to appointment of Non-Executive Director above age of 70? *Albiet*, Non-Executive position requires less time commitment.

SEBI has indirectly provided for this differential, when proposing that an Executive Director can have maximum 3 listed independent directorships, while permitting 7 for NEDs.

Having an executive director above the age of 70 clearly indicates the absence of succession planning and reflects poorly on functioning of Nomination and Remuneration Committee. The SEBI LODR Regulation also requires the Board to ensure that there is a plan for orderly succession for appointments to the Board and Senior Management. In practice, however, any such succession planning is hardly ever found or disclosed by the companies. A recent case highlights failure of succession plan when after almost 23 years at the helm as Chairman and Managing director, the person continues as NED with enlarged role in the name of smooth succession over next five years.

CONCLUSION

There is no dearth of good laws, yet there is a huge and fundamental disconnect between the law and the ground realty. The missing link is effective implementation and enforcement.

Enforcement can be through process of law or through shareholders participation. Resorting to implementation through legal means must be the last choice. Silver lining is that many investors and a lot of companies are willing to engage and zero on the steps required to improve their standards of corporate governance.

A message needs to go that compliance and good governance is not to please law makers but a path to lead to higher valuations. A demonstrating message should also go to corporates that compliance must be not only in letter but more importantly in spirit as well. Companies must change their DNA.

Further all investors including retail investors must engage with the companies they own, this will check compliance part and most of the compliance issues could be tackled with investor pressure, leaving a few big ones for the regulators to handle.