

# Recent Trends in Corporate Governance in India

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## 1. Background

The developments in the Corporate Governance sector, in India and outside, have a fairly long and interesting history. The current note will focus on the developments in this sphere in India in the last one decade. When the concept of corporations came into existence, the first set of issues of conflict was between the managers and the owners (shareholders), known as the agency problem. Till late 1970s, the Managing Director or the CEO could get the board that he/she wanted. There were some obvious problems with this set up and things started changing in the late 1970s, starting with USA SEC asking the NYSE that there should be independent directors amongst a few other changes. This was picked up in other parts of the world as well.

From the first level of conflict between the manager and the shareholders, the second level of conflict emerged between the dominant shareholders and the minority shareholders. Later, this led to another set of issues- which is, taking into account the interest of all the shareholders *versus* caring for all the stakeholders. The current regulatory thinking is that directors are responsible for protecting the interest of all the stakeholders. As such, the responsibility of independent directors today is much wider and deeper.

## 2. Key Agencies for Independent Directors to ensure Corporate Governance

In India, the legal position was clear post 2013 that the directors are responsible for all the stakeholders- employees, customers, community etc. But, the position remained a little vague so far as the creditors are concerned, as neither the Companies Act nor the SEBI LODR (Listing Obligations and Disclosure Requirements) mentioned creditors by name. There is a chapter in the LODR on principles where it was made clear by SEBI that in case of a conflict between the principle of governance and the language of the law, the principle will prevail. That was an important change in thinking and in legislative drafting from the past. Finally, when the IBC was enacted in 2016, the responsibility and obligation of the directors towards the creditors was specifically brought into the legislative framework.

Before IBC, the interest or issues related to creditors used to be at the bottom of the board agendas. But now there are very clear provisions about things like wrongful trading, the actions taken by the board in the twilight zone whether there has been any instance of asset stripping or any action taken against the interest of the creditors during the period of incipient stress on the company. There are court rulings in this context, including the Supreme Court of India, that if it is found that the directors have failed in their fiduciary duty, then they can be held personally liable. The accountability can extend to the extent of disgorgement from their personal assets.

Now in that situation, one has to understand:

- what is the role of Independent Directors as fiduciary while serving in the corporate boards
- what are the tools that are available to IDs
- who are the gatekeepers of governance or agencies that IDs can access for help and guidance

### ***2.1 Auditors***

The first option that immediately comes to mind is the auditors. They are guided by a very detailed set of regulations and guidelines which are revised regularly based on emerging challenges and are also guided by various international agreements. If the boards, especially the IDs, do not take note of the advice/recommendations of the auditors, or do not ask questions to the auditors on important issues like RPTs, key audit matters, internal financial controls etc, they will be failing in their duties. All boards have to develop their own culture about how they are going to interact with the auditors. There should be some structured method by which IDs can interact with the auditors and discuss various things which might be worrying them, or not understandable in the first instance. or soliciting their thinking on various issues. Auditors are the first set of people that we can think of as a great help and aid to the IDs and boards.

However, when we are talking about gatekeepers of governance, no one set of gatekeeper is ideal or comprehensive. There have been instances in the past and it can happen in the future where they may not function to the best of their abilities towards responsibilities assigned to them. At the same time, ignoring their contribution or not taking their help and guidance is not a good idea. Both the Companies Act as well as the SEBI regulations allow IDs to call auditors as and when needed. The Audit committee should take lead in facilitating such interactions.

### ***2.2 Proxy Advisory Firms***

Another gatekeeper is the proxy advisory firms, which are regulated entities in India. Regulation by SEBI has brought certain amount of discipline among them. Most of the time the management might feel that the proxy advisory firms are activists or trying to find faults or micro manage but the amount of information that they can provide, and well in time, can be a great help to the IDs whenever they are dealing with a particular situation. A company should develop a practice to thoroughly discuss whenever any red-flag has been raised by any proxy firm or any analyst.

### ***2.3 Rating Agencies***

The next gatekeeper is the rating agencies. In many boards, IDs or the board hardly ever discuss the recommendations of the proxy advisory firms or the status of the ratings of the company (upgrade or downgrade). These things provide lot of information about the company. Working of the securities market is entirely dependent upon how much information one gets and how timely such information is received. This was highlighted few years back in NSE when certain set of few brokers were getting access to information maybe a microseconds before the information was available to others which created a whole set of problems. Hence it is important to highlight recommendations made or any information shared by auditors, proxy advisory firms or rating agencies.

## 2.4 Whistle-blowers

Whistle-blowers are another example, where boards must discuss in detail the issues flagged. Frequency of same issues reported by whistle-blowers can also help in understanding the culture of the organisation. A company might be in the habit of calling board meetings at very short notice or not sharing the agenda for such meetings well in advance. The intent behind such practice needs to be looked into and rectified; the culture should be to rectify mistakes and not suppressing facts. For e.g. Kobe Steel, which used to supply high precision steel for nuclear and space industries, executives at different levels regularly suppressed findings on quality check and ended up paying heavy price for these acts. Similarly, in case of Volkswagen, where the company deliberately misrepresented to the authorities about emissions by their vehicles, the company had to pay a huge amount in fines, penalties, call back of vehicles and enter into settlements.

These are some of the areas where the IDs can be alert. SEBI and the Ministry of Corporate Affairs has prescribed that at least once in a year, there should be a meeting of Independent Directors, unaided by any other executive, is an important development. This should be used as an opportunity by the IDs to look at if anything unusual is happening. Directors are also within their rights to seek advice from any expert at any time.

## 3. Recent Regulatory Developments

SEBI has taken some important steps in its board meeting in Sept 2021 which are going to be extremely relevant for the IDs:

1. **The definition of Related Parties has been expanded:** Earlier a Related Party was one who had beneficial interest in the company up to 20% of the shareholding. This has been now reduced to 10% with effect from April 1, 2023. IDs have to be mindful now that the definition of Related Party is more stringent.
2. **The shareholder approval for a related party transaction:** The threshold for shareholders approval has been prescribed at the lower of Rs 1,000 crores or 10% of the consolidated turnover.
3. Another significant development, which can be problematic in the practical sense, is that SEBI has empowered itself to look at the intent or outcome of a transaction, which can be difficult to define and probe.
4. **The transaction between a subsidiary and the related party of the company** or any of the affiliates is also defined as a related party transaction.

A transaction between a subsidiary of an Indian listed company and any other related party such as promoters or an affiliate of the promoter, technically by the law of the land, was not defined to be a related party. However, at times, spirit of law may demand to go beyond the letter of law which is presented in the case study below.

### Case Study

An Indian listed company had a subsidiary registered outside India and the owner of the Indian company was again a company listed outside India. The subsidiary which was registered outside India had some surplus money and the promoters' parent company was short of liquidity. It was decided that the subsidiary of the Indian company can lend the money to the parent company (both registered outside India). The legal advice received by the company was that since the lending as well as the borrowing companies are not registered in India, it does not meet the related party threshold and hence there is no need to take the approval of the board or audit committee or shareholders of the Indian listed company.

When the matter came for information to the audit committee after three months as per regulation 25(4) of SEBI LODR, under which every important transaction has to be reported to the audit committee of the listed company, the audit committee felt that technically even if the transaction is in keeping with the letter of the law, it is against the spirit of the good governance. The Independent Directors met separately and decided to requisition a meeting of the full board within 24 hours. They conveyed their discomfort about the transaction and demanded that such transactions should be undertaken with the approval of the audit committee and the Board. Board had to accept the demand of the Independent Directors, the company policies were changed and it was decided that in the spirit of good governance, such transactions have to be approved by the audit committee. It was also decided to accelerate the repayments and to benchmark the rate of interest by an external agency based on the rating of the borrowing party and the same should be reset every quarter based on the financial condition of the borrower and its rating. The rate of interest was revised upwards from day one and the interest of the minority shareholders was protected.

This was reported during the annual results by the auditors that though the mistake has been rectified, it does indicate a material weakness in internal financial control. Some proxy advisory firm took up this issue and reported that the company has a weak internal finance control based on which they made certain recommendations against the directors.

This is an example to prove that while the Independent Directors went out of their way in following the spirit of governance, they still came under attack from certain proxy advisory firms. The larger lesson that Independent Directors can take from this case is that their actions are always under strict watch from multiple gatekeepers.

Another important development that will come into force from 1<sup>st</sup> of April 2022 is the SEBI decision on **separation of the chairman and managing director**. This was supposed to start from April 1, 2020 but for a variety of reasons and COVID-19 related challenges, it got deferred by two years. This move provides a very good opportunity for the Independent Directors to ensure that the governance standards in their companies are enhanced.

***ESG -Environmental, Social and Governance factors:***

Another important decision that SEBI has taken in the month of May 2021 is about the **Business Responsibility and Sustainability Reporting (BRSR)** requirements. BRSR is SEBI's way of focusing on ESG (Environmental, Social and Governance issues) and replaces the earlier Business Responsibility Report (BRR). For the current year, BRSR is voluntary for the top 1000 companies and will become mandatory for them from FY2022-23.

BRSR is a major improvement over the BRR and contains information that is quantifiable, standardised, verifiable and comparable. The information can be used by any analyst to compare the performance of companies on the given metrics. Unlike in the past, where it was very difficult for an investor or analyst to find how a company is performing on sustainability, BRSR provides comprehensive information. Though it is voluntary for the current year, some companies have started doing it for a smoother transition. They have to keep in mind that BRSR is not only about reporting, the information provided will be comparable and available to proxy advisory firms, analysts, institutional investors. SEBI has also come out with another requirement that domestic mutual funds cannot invest in companies which have not reported under BRSR.

At the international level, a major problem being faced by companies and investors is that there are so many different indices and reporting requirements all over the world. It becomes difficult to compare the performance of companies on sustainability parameters. In this direction important developments have taken place in the last one year. International Integrated Reporting Council (IIRC) got merged with Sustainable Accounting Standards Board (SASB) to create Value Reporting Foundation (VRF). SASB has come out with industry level ESG reporting guidelines for 77 industrial sectors. Now, the next stage is of VRF merging with IFRS (International Financial Reporting Standards Foundation) to create the International Sustainability Reporting Standards Board, ISSB

What is significant here is that just like the standards on financial reporting, which is largely accepted all over the world, hopefully, there can be uniform standards on sustainability reporting in the near future. There is also a very good chance of an international agreement in the near future on reporting on sustainability indices. Companies must prepare as they will find it very hard to hide behind a set of standards which they think are all right but the investors think that it does not meet their requirement.