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Corporate Governance

The days when an Indian company could sell its shares largely on the back of the India growth story are over. They may return but for now investor confidence has fallen to a new low and Indian issuers need to do more to boost investor trust if they are to attract new shareholders. This is particularly true if Indian issuers want to attract global investors who are now not only attuned to the variations which exist in corporate governance standards in different markets but also increasingly expect certain fundamentals of good corporate governance to be adhered to.

It is not surprising, therefore, that the Indian Companies Act 2013, which has just received Presidential assent, includes provisions dealing with corporate governance and Corporate Social Responsibility. With the implementation of these provisions, the corporate governance regime in India will look increasingly similar to global investors when they compare it to other jurisdictions, notably the US and the UK but also others such as Singapore and Hong Kong. However, the adoption of regulations is only part of the solution and while corporate governance rules in India may converge on a formal level, that has not yet translated into convergence in practice. It is unlikely that the provisions in the new Companies Act will be sufficient to achieve this without other, more fundamental changes. This should not be a surprise. A standard approach to regulation which does not take local differences into account is unlikely to be very successful.

India has its own corporate landscape. The largest Indian listed companies are Public Sector Undertakings ("PSUs") or family or promoter controlled companies.

It is true that the number of Indian companies with significant diverse minority shareholdings is increasing.

The funding of international and domestic expansion following economic liberalisation has meant that Indian companies have required more outside capital. The relaxation of some of the restrictions on foreign investment meant that a significant proportion of this capital was provided by foreign investors. Recent changes requiring 25% of the issued shares of listed companies in India to be in the hands of public (unconnected) shareholders will also have an impact. However, at the moment the vast majority of companies in India have controlling shareholders and this is likely to continue to be the case for many years.

This is quite a different picture from that in the US and the UK for example, where listed companies are generally not controlled by the State or by small groups of family or promoter investors.

These companies generally have diversified shareholder bases comprised of investors who are increasingly focused on corporate governance issues. In addition, stringent, often criminal, consequences exist for poor corporate governance.

The US approach is regulator led, mainly through detailed SEC regulation and US State law. The UK system is commonly referred to as 'principles based', where companies either comply with the governance requirements or explain how they do not comply. This system is underpinned by a robust system of company law and market regulation. Shareholders play an active role and are accorded genuine influence and enforcement rights. The US system is less reliant on shareholder engagement, although the threat of class action suits in the US can be an effective check on management.

India's corporate governance regime is contained in companies' legislation, which confers rights on shareholders, the Securities and

Exchange Board of India ("SEBI") Act and the requirements imposed on listed companies by SEBI, notably under Clause 49 of the Listing Agreement which they must enter into in order to be eligible for listing.

Despite these extensive provisions good corporate governance is not yet firmly ingrained in India. Given India's varied and developing corporate landscape it is unlikely that detailed regulations which are applicable to all listed companies will work. Some companies may not comply because they believe that they cannot, for example, because they have controlling shareholders who are also management. Others may purport to comply but history shows that companies which merely 'tick the boxes' of corporate governance requirements are not necessarily all that they appear to be. Enron and particularly Satyam, which purported to comply not only with Indian corporate governance requirements but also those imposed as a result of its NYSE listing, are good examples of this. Good corporate governance in India is most likely to be achieved through a mix of principles based standards and moderate regulations which will allow for the implementation of what are commonly accepted as fundamental principles of corporate governance whilst taking into account local differences. The 'comply or explain' nature of this system will encourage good practice above the legislative or regulatory requirements but, for the system to be effective, companies must be subject to a real obligation to 'comply or explain'. A flexible 'comply or explain' system will not work in the face of fraud, a lack of enforcement or shareholder apathy.

India does not have a history of shareholder activism. Other markets do but even they have had to take measures to encourage this. In the UK, for example, the recent Stewardship Code requires authorised asset management companies to disclose information about how they vote and manage conflicts. The fact that the UK also has an effective system of enforcement so that shareholder rights cannot be ignored also encourages shareholder engagement.

India is beginning to encourage more active shareholder involvement.

Mutual funds must now report on how they have voted on resolutions at company AGMs. The Companies Act 2013 expressly provides for statutory remedies for shareholders in the form of class actions and has taken these out of the courts (where they would be subject to delay). Class actions will be dealt with by the National Company Law Tribunal. The recent changes to the Indian Takeover Code, are also likely to encourage more independent shareholders. More independent shareholders will lead to more shareholder pressure for improved corporate governance.

In order to be effective in India, corporate governance regulations will need to take into account the defining characteristic of the Indian corporate landscape which is that of State, family or promoter controlling shareholders and protracted legal remedies.

These result in a general perception that the interests of minority shareholders are not adequately protected. There are a number of things that would help to overcome that perception.

Clause 49 of the Listing Agreement already provides for the optimum composition of the board (including the number of independent directors), the setting up of a qualified and independent audit committee, a remuneration committee, a management discussion and analysis ("MD&A") and a separate section on corporate governance to be included in the annual report, a quarterly compliance report on corporate governance be sent to the stock exchange and for the CFO or CEO to certify the financial statements. The Companies Act 2013 contains provisions which are intended to improve the process for the appointment of independent directors, clarify the duties of company directors, vest greater powers in shareholders and to facilitate shareholder class actions. However, more needs to be done for minority shareholders to have confidence that in practice the company's independent directors are not influenced by the controlling shareholder. The appointment process should be transparent, they should be demonstrably independent of the controlling shareholder, they should be qualified to perform their roles and willing to challenge senior management when it is appropriate to do so. Independent directors should receive training to ensure that they are aware of their responsibilities and the company should ensure that independent directors receive adequate information before a board meeting. The new Companies Act partially addresses this by making a nomination and remuneration committee a mandatory requirement. Hopefully this will bring about a more objective nomination process but the process could still be controlled by the majority shareholders.

Confidence in the reliability of corporate financial reporting and the audit is vital if companies are to attract external investment.

As much as possible should be done to allay any concerns that the auditor will be influenced by the controlling shareholder. The Companies Act 2013, contains provisions intended to ensure an auditor's impartiality (for example, by restricting the other roles they can perform for audit clients and by requiring the compulsory rotation of individual auditors every five years and of audit firms of listed companies every ten years), which will help. However, more needs to be done to ensure the credibility of the audit committee. The audit committee probably has the most demanding brief of any of the board committees. It should be comprised of independent directors with appropriate experience.

Companies should interact more with minority shareholders.

This means providing timely and good quality information (the quality of MD&A contained in some annual reports could be improved) and a willingness to listen to concerns expressed by minority shareholders. The corollary of this is that minority shareholders in India need to become more active and engaged (the process is beginning) and they need to feel that they have real remedies if companies ignore corporate governance rules. It is good news that India's first proxy advisory companies are now making an appearance. These firms, which advise institutional shareholders on how to vote on resolutions proposed by companies in which they are shareholders, are new to India. They are an important development.

Ultimately, good corporate governance in India will depend on the behaviour of management and controlling shareholders. Why should controlling shareholders facilitate this?

Apart from being right, good corporate governance is good for business. As Indian corporates become more global in their aspirations, overseas acquisitions and overseas listings will bring them into greater contact with international corporate governance requirements. They need to be able to meet these. Good corporate governance is fundamental to building trust and confidence and in today's nervous economic environment this is particularly important. It is becoming clear that good corporate governance could easily make the difference between success or failure in attracting new investors. In times of uncertainty, competition for funding is fierce. Companies needing money – and there are a lot of them and they are not just in India – will need to do more to boost confidence levels of nervous investors. When Indian corporates combine good corporate governance with their strong entrepreneurship and business acumen, they will be a formidable force.

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