

Anatomy and Limitations of a Legal-Centric Approach to Corporate Governance

K. P. Krishnan, C. K. G. Nair, Anupam Mitra

1. Introduction

Organisations and their interplay with stakeholders and the society at large have been fascinating areas of enquiry for several decades, and the emergence of institutionalism has greatly added to this fascination. Occasional episodes of corporate misadventures and misjudgements provided some more fodder for debate. Following the global financial crisis the need for governance in business organisations has been increasingly emphasised. The question that naturally follows is whether such a mission can be achieved with a legal-centric institutional mechanism, or whether the incentive structure resulting from the social norms has to weave in a higher order motive in business entities. This paper tries to explore this issue drawing on the experiences from some of the recent legal-centric initiatives.

Corporate governance (CG) is a mechanism meant to achieve the objectives of an organisation. But the perspective regarding the objectives varies depending on whether one is a promoter, a manager, or a customer. Undoubtedly, the primary objective from a customer's perspective would be the efficient production and delivery of the product by the organisation. If a car company delivers cars with inefficient brakes and accelerators, or a pharmaceutical company distributes substandard medicines it would result in huge social costs rather than benefits. No other socially responsible

activities can compensate for such a fundamental failure in their core functions. The CG approach that an entity adopts would therefore make a major difference to the society at large.

Definitions of CG vary widely, from the narrow concept of protecting the shareholder's money and interests, to the broader idea of furthering stakeholder interest. In its broadest sense, corporate governance encompasses issues of judicious and sustainable use of the resources of this planet to promote human welfare. This recognises the fact that in achieving economic growth a firm may involuntarily impose environmental and social costs. Corporate governance systems depend on the key principles of transparency, accountability, material disclosures, and equal treatment of all shareholders. However the relative emphasis on these principles depends on whether the ownership structure is concentrated or dispersed. Moreover since governance can be considered to be a "public good" (following the definition proposed in Samuelson (1954)¹, the market on its own may not ensure the optimal level of 'corporate governance'.

In the traditional sense, CG addresses the issue of the principal-agent problem in the context of a limited liability corporation where ownership lies in the hands of shareholders while the company is run by the management which need not necessarily be manned by the owners². The issue then is to align the interests of the principal (the equity holders)³ with those of the agent (the management). The problem inherent in aligning the interests of the principal with those of the agent is that it is difficult to write a complete contract that can specify desired management action for all contingencies. Moreover, the expectations from CG are now not confined to defining the contractual relationship of owners and managers in the narrow sense but extend to the relationship between different classes of owners, and between them and the management and with the stakeholders and society. It is a complex world of multiple principal-agent problems rendering legal contracting more complex and difficult with attendant imperfections in and incompleteness of such contracts.

Internationally CG is enforced through a mix of primary and secondary legislations— contractual rules which are to be complied with

mandatorily, and norms, codes, and ethical principles which the corporation can adopt voluntarily. The threat of takeover acts as a disciplining device where the market for corporate control is free. While a principle based regulation can partially address the limitations of the incomplete contract, in order to be effective in practice this would demand a very high quality of internal competence among regulators and integrity among firms. The rest of the paper are organised as follows. Section 2 traces the evolution of corporate governance practices in India and abroad. It also explores how a predominantly rule-based approach in India has failed to address the full spectrum of corporate governance issues. Section 3 explores the generic deficiencies of a rule-centred approach, drawing some examples of organisational forms and products. An alternate framework of CG is offered in Section 4.

2. Evolution of corporate governance norms

There have been several instances of spectacular business scams across the world that shook the corporate and financial world— such as the Enron and Worldcom scandals in the US, the Vivendi scandal in Europe, and the Satyam scandal in India. An analysis of the global financial crisis beginning 2007 also indicates the governance failure of corporates including the failure of gatekeepers like credit rating agencies and auditors on several counts. These corporate failures and events have underlined the importance of a proper governance mechanism even in the minimalist sense of ensuring that corporates properly and effectively do what they were established to do, and are accountable in a fair and transparent manner as they were expected to be.

Internationally, there have been a number of initiatives to streamline corporate governance practices. These include the Cadbury Report (1992)⁴, the Greenbury Report (1995)⁵, the Hampel Report (1998)⁶, the Turnbull Report (1999)⁷, the Higgs Report (2003)⁸, the Smith Report (2003)⁹, the Combined Code on Corporate Governance (2008)¹⁰ (all in the UK), and the Sarbanes-Oxley Act (2002) in the US, besides numerous other initiatives.

The Sarbanes-Oxley Act (2002) set new rules and standards relating to financial reporting, internal accounting, personal loans from companies to Directors, whistle blowing etc. for all the U.S. public company boards, management, and public accounting firms, with stringent penalties for violations. It also established a Public Company Accounting Oversight Board (PCAOB) for the regulation and monitoring of US audit and accounting firms. While the Act was a major milestone in the annals of legally-enforced CG norms, the crisis of 2007 came in as a black swan underscoring the limitations of such a legal-centric approach to CG.

CG norms in India have also evolved over the past couple of decades. In December 1995, the Confederation of Indian Industry (CII) set up a task force to design a voluntary code of CG. Between 1998 and 2000, 25 leading companies voluntarily followed the code. In 2000, The Securities and Exchange Board of India (SEBI) set up the Kumar Mangalam Birla Committee whose recommendations were implemented through the now famous Clause 49 of the stock exchange Listing Agreements, setting out mandatory and recommendatory provisions for the governance of listed companies. In early 2000, the government-appointed Sanjiva Reddy Committee issued its report on *Corporate Excellence through Governance*, setting out far reaching recommendations. The Ministry of Corporate Affairs soon after amended the Companies Act 1956 to incorporate specific corporate governance provisions regarding independent directors and audit committees. Since 2001, accounting standards were strengthened and expanded by the Institute of Chartered Accountants of India, and were notified under the Companies Act on the recommendation of the National Advisory Committee on Accounting Standards, to mandate appropriate compliance by companies. The Ministry of Corporate Affairs issued a set of voluntary guidelines for corporate governance in December 2009¹¹.

Introducing a CG framework in India is a complex task, coping as it must with the problems associated with very large numbers, and the ownership and management structures and operating cultures. A majority of these organisations are family owned; some are family owned but professionally run. Many are public limited but still fewer are listed. As of

March 2009, there were 7,86,774 companies operating in India which were limited by shares. Out of these around 7,04,716 companies were private limited companies and 82,058 companies were public limited. Of the public limited companies, a little less than 5000 were listed on the Bombay Stock Exchange. Many of the large publicly traded companies are in effect controlled by a few minority promoters. Bringing in a legal framework capable of encompassing these different subsets and effectively enforcing a regulatory frame is indeed fraught with complexities and difficulties.

A subset of these companies comprises what could be called *public institutions*, and they need specific mention. These are companies or business entities which are more like public utilities—their structure and conduct affect the society at large irrespective of whether one has a dealing with all of them or not. They are also called systemically important institutions. Banks, financial institutions, insurance companies, stock exchanges, pension funds, clearing corporations, etc. are all examples of public institutions. Many of these institutions may not be even listed entities. As such they do not have the greater disclosure and governance responsibilities embedded in the relevant legal framework. How to enhance their governing standards is another dimension that needs to be addressed.

Corporate governance in India practically revolves around Clause 49 of the Listing Agreement of SEBI, and some provisions in the Companies Act (1956) relating to audit, the constitution of boards of directors, the disqualification of directors, the restriction on the number of directorships etc. Clause 49 contains eight sections dealing with the composition and obligations of boards of directors, the scope of Audit Committees, the remuneration of directors, board procedure, management, shareholders, reports on corporate governance and compliance. The Clause requires that at least one-third of the board should consist of independent directors if the board is headed by a non-executive chairman. If promoters or their relatives are appointed as the non-executive chairman, then independent directors should constitute at least half the board strength, where independence is defined as the lack of any material, pecuniary relationship, or transactions

with the company, other than the director's remuneration, which in the judgement of the Board may affect a director's judgement.¹² It also stipulates that companies should have qualified and independent audit committees with a majority of independent directors, and that the Annual Report should disclose details of the remuneration of directors, and should contain all management discussions and analyses. Additionally, Annual Reports should contain a separate section on corporate governance detailing compliance with the mandatory and non-mandatory requirements proposed by SEBI.

How independent the independent directors can be in practice is a different matter, given that they could be handpicked by the promoters. The fact that the promoters themselves select and appoint independent directors involves a conflict of interest. This mode of selection creates a sense of obligation and loyalty to the promoters which can interfere with the independent, frank and unbiased expression of opinion which would be necessary to safeguard the interests of the other shareholders. Directors appointed to the boards by investing or lending institutions are expected to be more probing and scrutinising, though their role in the Indian context has remained inadequate.¹³ It is often suggested that in order to make independent directors truly independent, it is necessary for the government or the regulatory authority itself to appoint them. Today there is no mechanism by which an investor can access the views or expertise of an independent director; there is no platform from which an independent director can talk to a company's shareholders about his/her participation in board decisions that affect their interest. Even when a director wishes to resign, he/she has to depend on the company. He/she cannot on his/her own inform the authorities or the shareholders that he/she has resigned and would continue to be responsible to the shareholders in case of any delay by the company in notifying the authorities. Moreover shareholders are often unaware of whether (and why) a particular director or directors voted in favour of or against a move. If the summaries of board meetings, or more importantly the discussions that took place before an important decision is taken, are disclosed shareholders would be better informed.

3. Deficiencies of a legal-centric approach

The basic challenge of effective CG stems from the fact that it is difficult to measure human nature, motive, and behaviour and to create legislations that can control, modify, and regulate them. This remains true irrespective of whether the regulatory approach is principle-based or rule-based—both are more often than not observed in letter rather than in spirit as was demonstrated during the recent financial crisis. The emphasis on CG reforms has been on the functioning of the board of directors, and the various committees appointed by the board. Structural reforms in CG have centred on having a higher proportion of independent directors, on prescribing diverse sets of skills and expertise as the eligibility conditions to be a director, mandating regular attendance, ensuring the financial literacy of audit committee members, and setting up special purpose committees for key functions like executive compensation, risk management etc.

While efforts in the direction of making the boards more professional and independent are laudable, the outcome of such initiatives has been limited. Satyam Computer Services Limited had inducted highly reputed professionals into its board of directors. Few corporations could boast of more financial competencies and experience than what was possessed by that group of people. Yet the reputation of the company was badly tarnished when its founding chairman confessed to the falsification of accounts and other financial records of the company. Interestingly in Satyam the promoters did not even have a controlling stake.

While we can mandate attendance, can we legislate a director's involvement and quality of participation in the management of the company? Can codes and statutes prevent him from being a passive member of the board? It is possible that despite having an ideal composition, the board could be reduced to merely approving the decisions already made by select members of the board and the top management.

Similarly the financial reporting process and the quality of accounting can be streamlined and standardised to a certain extent for tangible assets, but the valuing of major intangible assets like human resources, brand,

customer franchise, organisational structure, intellectual capital, goodwill, etc. would still need to be done by the company in good faith. For instance, in order to measure the monetary value of human resources, it is generally accepted that the present value of the future earnings attributable to human resources needs to be considered. However a judgement has to be made on the appropriate discount rate among other factors. Again while calculating depreciation, an estimate of useful life needs to be made, which is more a matter of policy and judgement than a technical estimate.

The valuation of intangible assets plays an important role in mergers, acquisitions, and joint ventures. It gained importance with the emergence of knowledge based companies whose market capitalisations were a large multiple of their tangible asset values. Even the valuation of tangible assets can be challenging. Consider for instance a complex derivative for which there is very little liquidity in the market, and so the accountant cannot mark to market and is left with the option of marking to one of the various models available, each with its own sets of assumptions. Even with stringent regulations it is difficult to judge the fairness of all the related party transactions executed by the company. The Board through its audit committee is responsible for ensuring that the information disclosed is consistent, comparable, and complete as per law. A widely observed tendency is to observe this requirement by burdening shareholders/investors with a huge quantity of poor quality information that is incomprehensible and does not aid in assessing the worth of a company.

The subject of handling non-public, price sensitive information goes well beyond the scope of existing laws, and there are inherent limitations in enforcing many aspects of ethical conduct of market practices (for instance, to tackle insider trading¹⁴ and front running¹⁵) through legislative or regulatory means. Ethical market behaviour comes from education and the recognition of the need for control and avoidance of conflicts of interest. Firms must appreciate that by following good governance practices the corporate sector would be in a better position to enhance not only the economic value of the enterprise but also the value for every stakeholder who has contributed to the success of the enterprise. Sound and

efficient CG practices are the foundation for stimulating the performance of companies, maximising operational efficiency, achieving sustained productivity as well as ensuring protection of shareholders' interests. In particular, the role of professional analysts who assist investors in making investment decisions is very critical. Biases/conflicts emanating from personal affiliations and cross-holding by group companies need to be avoided. Since such decisions also involve subjective and judgemental issues, it is difficult to codify appropriate and best practices legally.

CG is manifested in a variety of conducts and practices like how sincerely (i.e. with what degree of factual accuracy) a product is advertised, how information is disseminated, whether disclosures are properly made etc. Often it is found that firms observe regulations in letter but not in spirit—there are hidden costs, expenses and risk factors which are conveniently glossed over to emphasise only the returns thereby conveying a wrong impression. Advertisements are often guilty of errors of omission (non disclosure or improper disclosure) and commission (making fictitious claims, selective disclosures highlighting performance in good times, or understating risks and overstating benefits). Various marketing gimmicks including mislabelling of products are employed, confusing the investor (Basu, 2006). Firms often try to push products that are unsuitable for the consumer but fetch high commission for the seller.

Financial innovation has been at times aimed at avoiding taxes, bypassing regulations, concealing leverage, confusing investors and reducing transparency. Das (2006) elaborates how such innovations were engineered to thwart competition and prevent clients from unbundling the product. Opaque, complex structured products became a lucrative source of commissions and rent. In the world of derivatives there are issues related to applying the appropriate valuation, etc. which are to some extent judgemental. Further, these are off balance sheet items and the risks posed by such instruments may not be apparent at when entering into a transaction. Credit Default Swap (CDS) is one such derivative that wreaked havoc during the recent financial crisis. CDS is in essence not a derivative product; it is basically an insurance product masquerading as a

derivative to bypass the legal requirement of an insurance licence to issue an insurance product. The problem of treating CDS as an insurance product is that the insurer has to prove *real loss* in order to claim the insurance. Treating CDS as an insurance (which it actually is) means that speculators cannot play in this market. Only hedgers and those entities who hold a particular bond can buy CDS. Not treating it as an insurance resulted in massive speculative activity so much so that the CDS claims exceeded the total amount of outstanding bonds of the reference entity. The unwinding of such highly leveraged positions exacerbated the financial crisis.

The Collateralised Debt Obligations (CDO) market also has a very opaque structure. This derivative involves tranching—partitioning of securities into various categories, depending on their risk and return. The end investor holding the CDOs is not fully aware of the inherent risks in such instruments. The Special Purpose Vehicle (SPV) created to facilitate the structuring of this product is an unregulated entity even as it indulges in shadow banking.

Private Equity (PE) funds are another group of companies that have serious corporate governance issues regarding their structure and mode of operation. The basic problem with PE funds starts with the fact that they are not a clearly defined entity, leading to difficulties in tethering them to CG rules and codes. The role of Credit Rating Agencies (CRAs) has come under the scanner in the wake of the financial crisis beginning 2007. While they were supposed to be professionally rating the debt and derivative instruments, they became party to the creation of highly rated complex instruments. CRAs and auditors are performing gate keeping role in the corporate/ financial sectors. As such they becoming partners in creating new instruments and rating them was in many ways a larger malady of CG framework.

4. An alternative framework of corporate governance

Given the limitations outlined in Section 3, there is a need to go beyond a legal-centric approach to CG if the larger societal aspirations are to be realised. Such an alternative approach would need a judicious mixture

of rule-based regulation and self-enforced codes. Ayers and Braithwaite (1992) assert that regulatory responsiveness should take into account the diversity in industry structure, levels of competitiveness, etc. and involve community participation; their concept of “escalating strategy” could be applied to CG as well. But, ironic as it may sound, there is the need for a sound legal-institutional structure to ensure that the norms and rules are practiced by the players. A legally empowered institutional structure would ensure this, while at the same time allowing the regulators to watch from the boundaries rather than being too inquisitive micro-managers.

The financial crisis has clearly shown that a pure Self Regulatory Organisation (SRO) model of self-enforcement is incapable of resolving issues related to conflicts of interest among the various members, since it usually degenerates into a business group lobby. The regulatory regime for corporate governance should be sensitive to the level of maturity attained by the market. An ethics enhanced incentive structure needs to be formulated. For an ideal market with a high level of financial literacy, a pyramidal structure for enforcing corporate governance can be considered, where the nature of regulation at each level has to be compatible with the maturity of the players, the number of players and the systemic risk they potentially pose.

One way to broad-base corporate governance norms or promote corporate democracy would be to increase public shareholding in listed companies. To be effective, public holding should also address issues of cross holding, pyramid ownership structures, and other mechanisms of control which have been extensively discussed in the context of holding company structures. It should also deal with the issue of *acting in concert* getting camouflaged, which is why not only the issue of threshold level of public holding is important, but also the definition of the terms public or promoter or both. Only entities which are directly or indirectly not linked to the promoters should become part of the *public*. Such entities are FIIs, Banks, Insurance Companies, Pension and Provident Funds, Mutual Funds, individuals/retailers, etc. On the other hand any entity having a stake directly or indirectly before the IPO of a company should be treated as a promoter.

Here again, while a threshold percentage of public share holding is important, the spirit behind enhancing corporate democracy is much more critical to CG. This underscores the norms vs. rules debate further. What is required is a reasonable share of public holding to ensure adequate liquidity and efficient price discovery, as well as respect for minority shareholders. In short, CG norms need to get woven into the structure of the organisations as well as into their conduct and practices. In this sense CG can be discussed in a structure-conduct-performance framework.

While attempting to bring forth the importance of a normative approach to CG, the endeavour of this paper is not to position it as a rule-centric vs. norm-centric issue. The framework has to be clear enough for an understanding of the boundaries of the rules and regulations on the one hand and those of the norms and values on the other. This framework should also decide the boundaries for the regulators involved. In a principle-based formulation, the interpretation of the principles is very important. For regulations, norms, codes, and statutes to be effective, proper and clear empowerment of the regulators administering them is essential. This would require greater awareness and financial literacy on the part of both the regulating and the regulated entities.

In conclusion, given the norm and value embedded nature of CG for an effective framework governing the code of conduct of business entities in defining their responsibilities towards the larger stakeholders, a mechanism of escalating strategy needs to be adopted, involving as it should public participation, self-enforced regulation, enforced regulation, command and control. This is the framework of the Braithwaite pyramid of escalating strategy wherein public interest, self-regulation, mandated self-regulation and a system of controls co-exist. For the success of such a system however, a sound legal framework is required. This needs to be reinforced with the first principles of norms and values. Only such a framework could liberate the mutuality of corporate action for the collective welfare of the society who is the ultimate stakeholder because no corporation or business entity exists in a vacuum. However, given the fact that visibility in a crowded environment is limited for any entity, the

supporting legal framework and the embedded code and values should provide heightened vision to them for assimilating the higher order objectives of their own existence.

References

- Ayers, I., & J. Braithwaite. (1992). *Responsive regulation: Transcending the deregulation debate*. USA: Oxford University Press.
- Basu, D. (2006). *Plain truths about Mutual Funds* (1st ed.). Kensource Information Services Pvt. Ltd.
- Cadbury Report. (1992). *Report of the committee on the financial aspects of corporate governance*. London. Gee Publishing.
- Das, S. (2007). *Traders, guns and money: Knowns and unknowns in the dazzling world of derivatives*. India: Prentice Hall.
- Ghosh, D. A. (2005). "Emerging corporate board practices". *Economic & Political Weekly*, 40(6), pp. 524–527, (5–11 February, 2005).
- Hampel Report. (1998). *The combined code: Principles of good governance and code of best practice*.
- Higgs Report. (1993). *Review of the role and effectiveness of non executive directors*.
- Mukherjee, S. (2004). "Corporate governance and development in India". In D. Reed & S. Mukherjee (Eds.), *Corporate governance, economic reforms, and development: The Indian experience* (pp 145–165). Oxford University Press.
- Samuelson, P. A. (1954). "The pure theory of public expenditure". *The Review of Economics and Statistics*, 36(4), pp. 387–389.
- Turnbull Report. (1999). *Internal control: Guidance for directors on the combined code*. London.
-

Notes

- ¹ Samuelson (1954) defines public goods as those whose consumption is non rivalrous and non excludable. According to the theory of public finance, goods with such attributes give rise to externalities affecting people not directly involved in the transaction. As a result there is either over production (in the case of negative externality) or under production (in the case of goods with positive externality) of such goods.

- ² While in the Anglo American model of corporate governance, the agency problem lies in making the management run the firm in the interests of shareholders, in the Indian context the primary agency problem has been between promoters (often with minority holdings) and minority shareholders. Such promoters are able to extend their sway over the company by taking advantage of the dispersed nature of shareholding, use of cross holding, and pyramidal corporate structures (Mukherjee, 2004).
- ³ Although debt holders are governed by mutual covenants and therefore are not owners/principals in the conventional sense, they do have a direct stake in the performance of the company and hence may be deemed to have an ownership stance in an extended sense.
- ⁴ The Cadbury Report (1992) focused attention on the board of directors' accounting and auditing functions, and emphasised the importance of institutional investors as the most influential group of shareholders. It also mandated that listed UK companies establish audit committees composed of non executive directors.
- ⁵ The Greenbury Report (1995) focused on identifying good practices in determining the remuneration of directors. Among other things, it recommended that the remuneration committee should consist exclusively of non executive directors. It also recommended full disclosure of pay and perks of directors in the Annual Report.
- ⁶ The Hampel Report (1998) emphasised the importance of maintaining principles based voluntary approach to corporate governance rather than following a prescriptive "box ticking" approach.
- ⁷ The Turnbull Report (1999) aimed to provide companies with general guidance on how to develop and maintain their internal control systems.
- ⁸ The Higgs Report (2003) dealt specifically with the role and effectiveness of non executive directors. The report suggested establishing strong links between non executive directors and companies' principal shareholders. In particular the report recommended that one non executive director assume chief responsibility of shareholder interest.
- ⁹ The Smith Report (2003) focused on the relationship between the external auditor and the companies they audit, as well as the role and responsibilities of companies' audit committees.
- ¹⁰ The Combined Code on Corporate Governance (2008) is not a rigid set of codes and rules. Rather it recognises that non compliance may be justified in particular circumstances if good governance can be achieved by other means. The Code follows a "comply or explain" approach.
- ¹¹ *Corporate Governance: Voluntary Guidelines 2009* brought out by the Ministry of Corporate Affairs has been proposed for voluntary adoption by the corporate sector, and takes into account the recommendations of the Task Force set up by CII under the chairmanship of Naresh Chandra in February 2009. The guidelines inter alia propose a clear demarcation of the roles and responsibilities of the chairman of the board and those of the managing director/ CEO to improve the balance of power, and to prevent the vesting of unfettered decision making power with a single individual. It also proposes a maximum tenure of six years for an individual to remain as an independent director with a cooling period of three years, and also restricts the number of companies in which an

individual may serve as an independent director to seven. According to the guidelines an independent director should not be paid stock options or profit-based commissions as that may compromise his independence. An interesting recommendation is to attach an “impact analysis on minority shareholders” for every agenda item in the board meeting. Further the independent directors should discuss such impact analysis and record their observations. The guidelines propose that audit partners should be rotated once every three years, while the audit firm should be rotated once every five years with a cooling period of three years. The companies are also requested to provide adequate safeguards against the victimisation of employees who avail of the whistle blowing mechanism, and to allow direct access to the chairperson of the Audit Committee in exceptional cases.

- ¹² Mukherjee (2004) is sceptical as to whether a simple majority of outside directors is an indication of board independence given the influence that promoters yield in the selection of outside board members.
- ¹³ Ghosh (2005) discusses that in the US and the UK, there is an active market for corporate control to discipline managers, while in Japan and Germany, the main bank that finances the corporation acts as an external disciplining entity.
- ¹⁴ Insider trading refers to trading that takes advantage of non-public information which is often available to an insider of the organisation. It refers to an act of buying, selling, or dealing in securities by any person while in possession of unpublished price sensitive information relating to such securities.
- ¹⁵ Front running is an activity in which a trader takes a position of unfair advantage in advance of a large buy or sell order that the trader knows will move the price of that equity in a predictable fashion. Direct market access—which is a facility allowing clients direct access to the exchange trading system through the brokers’ infrastructure without manual intervention by the broker—can tackle this problem to some extent.