EVOLUTION OF LEGAL FRAMEWORK OF CORPORATE GOVERNANCE

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CORPORATE GOVERNANCE – AN INTRODUCTION

- The term "governance" means control i.e. controlling a company, an organization etc or a company & corporate governance is governing or controlling the corporate bodies i.e. ethics, values, principles, morals. For corporate governance to be good the manager needs to meet its responsibilities towards its owners (shareholders), creditors, employees, customers, government and the society at large. Corporate governance helps in establishing a system where a director is showered with duties and responsibilities of the affairs of the company.
- For effective corporate governance, its policies need to be such that the directors of the company should not abuse their power and instead should understand their duties and responsibilities towards the company and should act in the best interests of the company in the broadest sense.

DIFFERENT DEFINITIONS OF CORPORATE GOVERNANCE

- Cadbury Committee (U.K.), 1992 has defined corporate governance as such :

  "Corporate governance is the system by which companies are directed and controlled. It encompasses the entire mechanics of the functioning of a company and attempts to put in place a system of checks and balances between the shareholders, directors, employees, auditor and the management."

- OECD principles of corporate governance (1999) defines the term as:

  "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides this; it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."

DIFFERENT DEFINITIONS OF CORPORATE GOVERNANCE

- Definition of corporate governance by the Institute of Company Secretaries of India is as under:

  "Corporate Governance is the application of best Management practices, Compliance of law in true letter and spirit and adherence to ethical standards for Effective Management and distribution of wealth and discharge of social Responsibility for sustainable development of all stakeholders".

EVOLUTION OF LEGAL FRAMEWORK OF CG

- The issue of governance began with the beginning of corporations, dating back to the East India Company, the Hudson's Bay Company, the Levant Company and other major chartered companies during the 16th and 17th centuries.
- It was a term that was only used in the United States. The balance of power and decision-making between board directors, executives and shareholders has been evolving for centuries.
- The theme of corporate governance has attained prominence particularly since the 1980s and all the more so after the code of corporate administration issued by the Cadbury advisory group. The well-known Cadbury Committee characterised “corporate governance” in its report (Financial Aspects of Corporate Governance, distributed in 1992) as “the framework by which organisations are coordinated and controlled”.

EVOLUTION OF LEGAL FRAMEWORK OF CG – US

- After World War II, the United States experienced strong economic growth, which had a strong impact on the history of corporate governance. Corporations were thriving and growing rapidly.
- Managers primarily called the shots and board directors and shareholders were expected to follow. In most cases, they did. This was an interesting dichotomy, since managers highly influenced the selection of board directors.

EVOLUTION OF LEGAL FRAMEWORK OF CG – US

- Unless it came to matters of dividends and stock prices, investors tended to steer clear from governance matters.
- In the 1970s, things began to change as the Securities and Exchange Commission (SEC) brought the issue of corporate governance to the forefront when they brought a stance on official corporate governance reforms.
- In 1976, the term 'corporate governance' first appeared in the Federal Register, the official journal of the federal government.

EVOLUTION OF LEGAL FRAMEWORK OF CG – US

- In the 1960s, the Penn Central Railway had diversified by starting pipelines, hotels, industrial parks and commercial real estate. Penn Central filed for bankruptcy in 1970 and the board came under public fire.
- In 1974, the SEC brought proceedings against three outside directors for misrepresenting the company's financial condition and a wide range of misconduct by Penn Central executives. Around the same time, the SEC caught on to widespread payments by corporations to foreign officials over falsifying corporate records.

EVOLUTION OF LEGAL FRAMEWORK OF CG – US

- During this era, corporations started to form audit committees and appoint more outside directors. In 1976, the SEC prompted the New York Stock Exchange (NYSE) to require each listed corporation to have an audit committee composed of all independent board directors, and they complied. Advocates pushed to get governance right by requiring audit committees, nomination committees, compensation committees and only one managerial appointee.
- The 1980s brought an end to the 1970s movement for corporate governance reform due to a political shift to the right and a more conservative Congress. This era brought much opposition to deregulation, which was another major change in the history of corporate governance. Lawmakers put forth The Protection of Shareholders' Rights Act of 1980, but it was stalled in Congress.

EVOLUTION OF LEGAL FRAMEWORK OF CG – US

- Debates on corporate governance focused on a new project called the Principles of Corporate Governance by the American Law Institute (ALI) in 1981.
- The NYSE had previously supported this project, but changed their stance after they reviewed the first draft. The Business Roundtable also opposed ALI's attempts at reform. Advocates for corporations felt they were strong enough to oppose regulatory reform outright, without the restrictive ALI-led reforms.
- Businesses had concerns about some of the issues in Tentative Draft No. 1 of the Principles of Corporative Governance. The draft recommended that boards appoint a majority of independent directors and establish audit and nominating committees. Corporate advocates were concerned that if companies implemented these measures, it would increase liability risks for board directors.

EVOLUTION OF LEGAL FRAMEWORK OF CG – US

- In the end, the final version of ALI's Principles of Corporate Governance was so watered down that it had little impact by the time it was approved and published in 1994. Scholars maintained that market mechanisms would keep managers and shareholders aligned.
- The 1980s was also referred to as the 'Deal Decade.' Institutional shareholders grabbed more shares, which gave them more control. They stopped selling out when times got tough. Executives went on the defensive and struck deals to prevent hostile takeovers.
- State legislators countered takeovers with anti-takeover statutes at the state level. That, combined with an increased debt market and an economic downturn, discouraged merger activity.

EVOLUTION OF LEGAL FRAMEWORK OF CG – US

- The Institutional Shareholder Services (ISS) was formed to help with voting rights. Shareholders struck back with legal defenses, but judges often favored corporate decisions when outside directors supported board decisions. Investors started to advocate for more independent directors and to base executive pay on performance, rather than corporate size.
- The collapse of the Lehman Brothers bank on *September 15, 2008* developed into a major international banking crisis, which became the worst financial crisis since the Great Depression in the 1930s.
- Congress passed the ***Dodd-Frank Wall Street Reform and Consumer Act in 2010*** to promote financial stability in the United States.

EVOLUTION OF LEGAL FRAMEWORK OF CG – US

- The fallout from the financial crisis has placed a heavier focus on best practices for corporate governance principles. Boards of directors feel more pressure than ever before to be transparent and accountable.
- Strong governance principles encourage corporations to have a majority of independent directors and to encourage well-composed, diverse boards.

EVOLUTION OF LEGAL FRAMEWORK OF CG – INDIA

PRIOR TO INDEPENDENCE

- Indian associations/corporate entities were bound by colonial guidelines and a large portion of the principles and guidelines took into account the impulses and likes of the British employers.
  - The Companies Act was enacted in 1866 and was amended in 1882, 1913 and 1932.
  - Partnership Act was enacted in 1932.
- These enactments had a managing organisation model as a focus as people/business firms went into a legitimate contract with business entities to manage the latter.
- This period was an era of misuse/abuse of resources and shunning of obligations by managing specialists because of scattered and unprofessional proprietorship.

EVOLUTION OF LEGAL FRAMEWORK OF CG – INDIA

POST INDEPENDENCE

- Soon after independence, there was interest among industrialists for production of a lot of essential items for which the Government directed and dictated fair prices.
  - This was the point at which the **Tariff Commission and the Bureau of Industrial Costs and Prices** were set up by the Government.
  - Industries (Development and Regulation) Act and Companies Act were introduced into the legal system in 1950s.
  - 1960s was a time of setting up of heavy industries in addition to the routine affairs.
  - The period between 1970s to mid-1980s was a time of cost, volume and profit examination, as a vital piece of the cost accounting activities.

REFORMATION IN CORPORATE GOVERNANCE

The First Phase of India's Corporate Governance Reforms: 1996-2008

(a) CII—1996

In 1996, CII taking up the first institutional initiative in the Indian industry took a special step on corporate governance. The aim was to promote and develop a code for companies, be in the public sectors or private sectors, financial institutions or banks, all the corporate entities. The steps taken by CII addressed public concerns regarding the security of the interest and concern of investors, especially the small investors; the promotion and encouragement of transparency within industry and business, the necessity to proceed towards international standards of disclosure of information by corporate bodies, and through all of this to build a high level of people's confidence in business and industry. The final draft of this Code was introduced in April 1998

REFORMATION IN CORPORATE GOVERNANCE

(b) Report of the Committee (Kumar Mangalam Birla) on Corporate Governance

Noted industrialist, Mr Kumar Mangalam Birla was appointed by SEBI—as Chairman to provide a comprehensive vista of the concern related to insider trading to secure the rights of several investors. The suggestions insisted on the listed companies for initial and continuing disclosures in a phased manner within specified dates, through the listing agreement. The companies were made to disclose separately in their annual reports, a report on corporate governance delineating the steps they have taken to comply with the recommendations of the Committee. The objective was to enable the shareholders to know, where the companies, in which they have invested, stand with respect to specific initiatives taken to ensure robust corporate governance.

REFORMATION IN CORPORATE GOVERNANCE

(c) Clause 49

The Committee also realised the importance of auditing body and made many specific suggestions related to the constitution and function of Board Audit Committees. At that time, SEBI reviewed it's listing contract to include the recommendations. These rules and regulations were listed in Clause 49, a new section of the listing agreement which came into force in phases of 2000 and 2003.

(d) Report of the Advisory Group on Corporate Governance: Standing Committee on International Financial Standards and Code—March 2001

The advisory group tried to compare the potion of corporate governance in India vis-à-vis the international best standards and advised to improve corporate governance standards in India.

REFORMATION IN CORPORATE GOVERNANCE

(e) Report of the Consultative Group of Directors of Banks—April 2001

The corporate governance of directors of banks and financial institutions was constituted by Reserve Bank to review the supervisory role of boards of banks and financial institutions and to get feedback on the activities of the boards vis-à-vis compliance, transparency, disclosures, audit committees, etc. and provide suggestions for making the role of Board of Directors more effective with a perspective to mitigate or reduce the risks.

REFORMATION IN CORPORATE GOVERNANCE

(f) Report of the Committee (Naresh Chandra) on Corporate Audit and Governance Committee—December 2002

- The Committee took the charge of the task to analyse, and suggest changes in different areas like—the statutory auditor and company relationship, procedure for appointment of Auditors and determination of audit fee, restrictions if required on non-auditory fee, measures to ensure that management and companies put forth a true and fair statement of financial affairs of the company.

(g) SEBI Report on Corporate Governance (N.R. Narayan Murthy)—February 2003

- So as to improve the governance standards, SEBI constituted a committee to study the role of independent directors, related parties, risk management, directorship and director compensation, codes of conduct and financial disclosures.

REFORMATION IN CORPORATE GOVERNANCE

(h) (Naresh Chandra Committee II) Report of the Committee on Regulation of Private Companies and Partnerships

- As large number of private sector companies were coming into the picture there was a need to revisit the law again. In order to build upon this framework, the Government constituted a committee in January 2003, to ensure a scientific and rational regulatory environment. The main focus of this report was on (a) the Companies Act, 1956; and (b) the Partnership Act, 1932. The final report was submitted on 23-7-2003.

REFORMATION IN CORPORATE GOVERNANCE

(i) Clause 49 Amendment—Murthy Committee

- In 2004, SEBI further brought about changes in Clause 49 in accordance with the Murthy Committee's recommendations. However, implementation of these changes was postponed till 1-1-2006 because of lack of preparedness and industry resistance to accept such wide-ranging reforms. While there were many changes to Clause 49 as a result of the Murthy Report, governance requirements with respect to corporate boards, audit committees, shareholder disclosure, and CEO/CFO certification of internal controls constituted the largest transformation of the governance and disclosure standards of Indian companies

REFORMATION IN CORPORATE GOVERNANCE

Second Stage of Corporate Governance—After Satyam Scam

- In January 2009 – damaging revelations about board failure and colossal fraud in the financials of Satyam.
- The Satyam scandal also served as a catalyst for the Indian Government to rethink the corporate governance, disclosure, accountability and enforcement mechanisms in place.
- Industry response shortly after news of the scandal broke, the CII began examining the corporate governance issues arising out of the Satyam scandal. Other industry groups also formed corporate governance and Ethics Committees to study the impact and lessons of the scandal. In late 2009, a CII task force put forth corporate governance reform recommendations.

REFORMATION IN CORPORATE GOVERNANCE

- In its *report* the CII (2009-10) emphasised the unique nature of the Satyam scandal, noting that—Satyam is a one-off incident. The overwhelming majority of corporate India is well run, well regulated and does business in a sound and legal manner.
- In addition to the CII, the ***National Association of Software and Services Companies*** (**NASSCOM**, self-described as—the premier trade body and the Chamber of Commerce of the IT-BPO industries in India) also formed a Corporate Governance and Ethics Committee, chaired by ***N.R. Narayana Murthy***, one of the founders of Infosys and a leading figure in Indian corporate governance reforms. The Committee issued its recommendations in mid-2010

LEGAL FRAMEWORK ON CORPORATE GOVERNANCE

- ***The Companies Act, 2013* —** consists of law provisions concerning the constitution of the board, board processes, board meetings, independent directors, audit committees, general meetings, party transactions, disclosure requirements in the financial statements and etc.
- ***SEBI Guidelines* —** SEBI is a governing authority having jurisdiction and power over listed companies and which issues regulations, rules and guidelines to companies to ensure the protection of investors.
- ***Standard Listing Agreement of Stock Exchanges* —** is for those companies whose shares are listed on the stock exchanges.

LEGAL FRAMEWORK ON CORPORATE GOVERNANCE

- ***Accounting Standards Issued by the Institute of Chartered Accountants of India (ICAI).—*** ICAI is an independent body, which issues accounting standards providing guidelines for disclosures of financial information. In the new Companies Act, 2013 Section 129 provides that the financial statements would give a fair view of the state of affairs of the companies, following the accounting standards given under Section 133 of the Companies Act, 2013. It is further given that the things contained in such financial statements should be in compliance with the accounting standards.
- ***Secretarial Standards issued by the Institute of Company Secretaries of India (ICSI).—***ICSI is an independent body, which has secretarial standards in terms of the provisions of the new Companies Act. ICSI has issued secretarial standards on "Meetings of the Board of Directors" (SS-1) and secretarial standards on "General Meetings" (SS-2). Given secretarial standards have come into force from 1-7-2015. Companies Act, 2013, Section 118(10) provides that every company (other than one person company) shall observe secretarial standards specified as such by the ICSI with respect to general and Board meetings.