India’s Current Corporate Governance Practices – Impact & Challenges

ABSTRACT

Corporate governance has been given different definitions by different experts and has been continuously recognized as one of the primary factors that affect the performance of a company in the long run. It is one of the most important factors fulfilling all investor protection related grievances in a company. In light of establishing the above view, we shall look into the following questions in detail in the course of this article, in other words:

i. "Is corporate governance essential for companies?"
ii. "Is corporate governance an impediment to growth?" and
iii. "Is the current legal regime with respect to corporate governance in India functioning adequately at the practical level and does it take into account the interests of all the stakeholders that are affected by it?"

In the course of finding the answers to the above questions, the article discusses various relevant issues faced by companies with respect to complying with corporate governance norms in multiple jurisdictions, the intermingling between private equity sector and corporate governance, the need to change whistle-blower laws, insider trading, forensic audit, and the enforcement framework prevalent against corporates in India. This article further concludes by suggesting some reforms which need to be executed so as to enhance the effectiveness of the current legal regime with respect to corporate governance in India.

I. Introduction

The Securities and Exchange Board of India’s (“SEBI”) consultative paper on the review of corporate governance norms in India defines corporate governance as the acceptance by management of the inalienable rights of the shareholders as the true owners of the corporation and their roles as trustees on behalf of the shareholders. It has been further defined as a commitment to values, ethical business conduct, and to making a difference in managing the company’s personal and corporate funds. The importance of corporate governance has once again gained prominence in recent times on account of Satyam and Enron fiascos. This article aims to highlight the main issues with the implementation of various corporate governance clauses 49 as contained under the Indian legal framework. Some of the important themes to be addressed in the course of the article are as follows:

Cross jurisdictional compliance by Indian companies abroad and foreign companies in India;
Corporate governance and the private equity sector;
Certain changes required to be made to Clause 49 of SEBI’s Listing Agreement (“Clause 49”);
Whistle-blower’s policy in India and its effect on corporate governance;
Insider trading related law in India and its effect on corporate governance;
Forensic audit in India; and
Effective enforcement by relevant regulators.

II. Legal framework of corporate governance for Indian companies

The basic framework for regulation of all companies in India is contained in the Companies Act, 1956, which provides for checks and balances over the powers of the Board of Directors. In addition, under the Securities Contracts (Regulation) Act, 1956, every listed company in India needs to comply with the Listing Agreement stipulated by SEBI. It must be noted that Clause 49 has been the mainstay of corporate governance in India for more than a decade. Although such norms are expected to keep pace with the ever changing corporate circumstances, the previous detailed review of Clause 49 was back in 2004 and revised norms came into effect in January, 2006. Since then, most of the changes and proposals have been introduced by the Central Government by way of Ministry of Corporate Affairs’ Voluntary Guidelines of 2009 and substantial insertions on corporate governance issues in the Companies Bill, 2012, which is awaiting enactment.

III. Co-relationship between corporate governance and financial performance of companies

"Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?"

- Edward, First Baron Thurlow
Despite rapid growth, corporate governance has been very weak in China, with ills such as concentration of state ownership, lack of independence among Boards, insider trading, false financial disclosures, and immature capital markets. Nevertheless China still has more foreign direct investment ("FDI") than India in spite of the perceived superior corporate governance in India. This only leads us to a conclusion that, perhaps, investors flock at companies for the returns it gives and corporate governance is only a hygiene factor. The rule of law and formal system of property rights have not been the most essential aspects in explaining FDI inflows within Chinese regions which raises the larger issue as to what the difference is. This also implies that a Chinese business leader who has a long-term career horizon and who cares about his or her reputation may be able to attract more investment.

On the contrary: In 2001, United States of America ("U.S.") was rocked by the collapse of Enron, a multimillion dollar corporation that employed thousands of people. Only months before Enron's bankruptcy filing in December 2001, the firm was widely regarded as one of the most innovative, fastest growing, and best managed businesses in the United States. With the swift collapse, shareholders - including thousands of Enron workers who held company stock in their retirement accounts - lost tens of billions of dollars. Enron had earlier reported annual revenues which grew from under $10 billion in the early 1990s to $101 billion in 2000, ranking it seventh on the list of Fortune 500 companies then. The collapse of Enron was largely ascribed to the manipulation of the corporate governance norms by Enron's management.

More recently, shares of India's second largest software services exporter Infosys fell by a margin of 3.9% on reports that the company is under scrutiny by the United States Department of Homeland Security for errors in the employer eligibility documents of its staff working in the U.S. Furthermore, the shares of Sun TV and SpiceJet fell down immediately by 31% and 13.5% respectively as the brother of the Chairman of the two companies was said to be involved in the 2G Spectrum scam. Further, shares of ICICI Bank, Axis Bank, and HDFC Bank were largely unmoved by the Cobrapost.com piece that charged these banks with abetting and money laundering. ICICI Bank shares were up slightly, while Axis Bank and HDFC Bank shares were marginally down. The above examples show a direct relationship between stock prices of a company and the non-compliance of the company or any person who is a part of the company’s management to certain laws.

Also in India recently, The Children’s Investment Fund Management ("TCI") has accused Coal India Limited ("CIL") of improper and unprofitable practices. TCI, a minority stakeholder of Coal India had, on March 5, 2013, sent a letter to the CIL’s directors alleging that the incumbent chairman of CIL was incompetent in protecting CIL’s net income from erosion by rising diesel and wage costs and general inflationary pressures. This incident once again threw light on a legal system which has not been able to assure adequate levels of corporate governance in India.

However, in a country like India corruption has been considered to be a socio-political malaise with every sector of Indian society being a part of the corruption culture.

On the other hand, scholars such as Milton Friedman opine that there is one and only one social responsibility of business, which is to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game. That is to say, it engages in open and free competition without deception or fraud. It is largely considered that unlike political governance, corporate governance is primarily contractual in nature, and corporate governance is at the bottom of enforcing the spirit of this contractual relationship. Studies have shown that in advanced nations like U.S, not many companies are concerned about values and instead focus exclusively on maximizing profits. The argument here isn’t that Managers and Boards always know best, it’s simply that widely dispersed short-term shareholders are unlikely to know better and that a governance system that relies on them to keep corporations on the straight and narrow is doomed to fail.

So, does it mean that the investors in India care about corporate governance at all? Several studies in India and abroad have indicated that markets and investors take notice of well managed companies and respond positively to them. Better governed firms have been observed to carry higher stock prices and vice versa. This has been attributed to the fact that better managed firms will perform better and as a result stock prices will increase.

It is important to note that the components that are usually considered while assessing the status of corporate governance in a company are Board independence, Chief Executive Officer ("CEO") duality, existence of Remuneration and Nomination Committees and the existence and expertise of Audit Committee. For example these structures can be seen in well-managed companies such as HDFC, Infosys Technologies Private Limited ("Infosys"), ITC Limited etc. These companies enjoy a tremendous amount of market good will which carries them through tough times. It has been found that better-governed corporate
frameworks benefit companies by giving them greater access to financing, lower cost of capital, better firm performance, and more favorable treatment meted out to of all the stakeholders of a company. In India, studies show that SEBI's regulation on corporate governance has been effective in providing more timely information to the investors, who in turn could use the information to determine appropriate risks of the stocks and thereby maximize the shareholder’s wealth.

It can hence be safely concluded that better corporate governance can lead to increased access to external financing by a firm which in turn leads to larger investment, higher growth, and greater employment creation. Also, good corporate governance can generally produce better relationships with stakeholders - which helps improve social and labour relationships. It is hard for investors to have confidence in a company with a weak corporate governance mechanism or in a regulatory framework which has been found to be repeatedly ineffective. Corporate governance is incredibly important as it manifests itself in a company’s long-term performance. It therefore must be noted that well-run companies tend to have support of shareholders, suffer less volatility at times of maximum stress, with less severe share price falls and that corporate governance goes hand in hand with the long term financial performance of a company and is directly affected by the strength of the legal framework which is applicable to corporates.

IV. Cross jurisdictional compliance

Recently, Japanese drugmaker Daiichi Sankyo Co - which bought control of India headquartered Ranbaxy Laboratories in 2008 - said that it believed that certain unnamed former shareholders of the company had hid information regarding regulatory probes by U.S into Ranbaxy. Additionally, Ranbaxy pleaded guilty to felony charges related to drug safety and agreed to pay $500 million in civil and criminal fines under a settlement with the United States Department of Justice. Furthermore, a European regulator is to find Ranbaxy and seven other makers of generic drugs for limiting the supply of cheaper medicines. This shows that outbound Indian business entities would be at the risk of ensuring corporate governance in the various jurisdictions they operate and in the absence of the same potential risks, liabilities may arise. It is now widely accepted that the corporate governance system varies across nations. Ownership and board structures, managerial incentives, the role of banks and large financial institutions, the size and development of stock markets, company law, securities regulation, government involvement and other important aspects of corporate governance have been found to differ across nations. As of today, companies are not confined to one country only. They have crossed the borders of India and have presence in many countries. In India, for example norms are less severe for acquiring unlisted companies but it may not be the same in other countries. But what works in one country does not work in the other and accordingly what works in India may not be applicable elsewhere. There are always cultural differences that can be observed between the legal regimes of any two nations.

We have briefly looked at one sector - namely information technology companies who have strong businesses outside India. There are various governance related laws to be adhered to by the information technology companies which are based in India but have substantial operations abroad. It has been observed that Indian software and other companies listed overseas, especially in the U.S, followed the principles of voluntarily imbibing greater measures of corporate governance for the perceived value it created for their businesses. For example, Infosys is compliant with Section 404 of the Sarbanes Oxley Act of 2002 (“SOX Act”). All companies, including Indian companies, which are listed on U.S stock exchanges, are required to comply with the requirements of the SOX Act. The other way round, all foreign companies listed on stock exchanges in India have to comply with SEBI’s Listing Agreement. Cross jurisdictional compliance has been a major driving factor which ensures that Indian companies that have been listed in a stock market under a foreign jurisdiction also comply with local Indian laws. However, though there are always more strings attached to compliance in multiple jurisdictions by corporations, the governance system being complied with by the company should typically be more stringent of the two.

With respect to compliance by foreign companies functioning in India, it is important to note that recently an internal corruption probe lead Walmart to suspend associates in India and Reebok to write off losses due to corporate fraud in India. Does this mean that multinational corporations (“MNC”) in a rush to open stores and grab business end up lowering their corporate governance standards in emerging markets like India or do countries such as India and China perplex them with their unique challenges? It has been found that more often than not, India is the only country outside the home market where they have a listed entity. So the Board and senior management are seldom quite unaware as to how to deal with this. The focus is always on compliance with regulations in the home market, with the compliance in Indian subsidiaries being sidelined. It is important to note that the senior management in such Indian companies are invariably brought in or appointed by the foreign based parent companies and their future career paths in the group and incentives are controlled by the parent companies. As a result, focusing on transfer of profits to the parent company has become a priority to the Indian management of such foreign based companies functional in India. It has further been found that there have been instances where the parent MNCs have
informed local CEOs clearly that they do not have to bother about local investors but should focus on their foreign shareholders. The conflict of global profit is at the cost of local profit and is very much tilted in the favor of the parent company. The Indian listed subsidiaries, or associates of MNCs, rarely show concern for local investors and often compromise on standards. Additionally in India, there have been instances where MNCs have merged or restructured assets between their wholly owned subsidiaries and the Indian listed company. Such restructuring of businesses have been done at valuations that are clearly unfavorable to minority shareholders. Both analysts and shareholder advisory firms are unanimous in their view that MNCs on paper have better corporate governance standard at the parent level compared to most of their Indian peers. This brings us to the conclusion that many foreign based companies which are functional in India are being let off without strict actions being taken against their non-compliance with the domestic laws.

V. Corporate governance and the private equity sector:

The Indian economy has been showing a gradual and consistent shift from the manufacturing sector to the service sector. Private equity as an industry has become a prominent mode of finance companies involved in the service sector. The past century saw some of the current information technology giants turning to this sector for mobilizing the initial capital. In India, currently the sudden spurt of domestic e-commerce sites can be attributed to the private equity investors. Companies belonging to the service sector are relying largely on private equity players to mobilize funds as opposed to opting for loans from banks and funds raised from initial public offering which are preferred mainly by companies in the manufacturing sector such as those companies involved in housing and construction industry. Hence, in case of startups for which traditional means of financing are not available, funds made available by private equity players is a boon. It is important to distinguish between good governance and bad governance in companies with respect to the private equity industry, mainly because the presence or absence of good governance can act as a deterrent or a catalyst towards attracting investment by companies eyeing private equity firms to raise capital.

Industry experts we spoke to have given us very useful insights with respect to how corporate governance norms can be made applicable in the private equity industry with respect to prospective investee companies. Based on discussions it has been found that private equity investors give importance to compliance with corporate governance norms in startups so that such startups can attract substantial investments in the future. In practice, private equity investors do distinguish between the corporate governance standards insisted by them in startups as against companies which are sufficiently well established. In startups which have just begun functioning, corporate governance levels are minimal. In practice, as soon as a Nominee Director is appointed by the private equity firm on the Board of startups, corporate governance is assured to be given importance. Compliance with corporate governance provisions which are binding on a company are taken care of by incorporating the same into the shareholders agreement. The private equity investors keep a tight grip on corporate governance in such companies aiming at greater transparency by listing reserved matters in the shareholders agreement, which are always decided in consultation with the private equity investors and also by them having a say on what would constitute a quorum for the purpose of a Board meeting of the investee company post investment. All these aspects (Nominee Director, quorum requirements) are subsequently incorporated into the Articles of Association of the investee company. Also in practice, private equity investors insist that labour laws and any compliance as required under Companies Act, 1956 is complied with by the investee company prior to such investment. It is interesting to note that private equity investors generally insist on minimal secretarial compliance in investee companies that are startups, instead of strict legal compliance which is usually insisted upon in established companies. Also, private equity investors usually appoint Chartered Accountants in bigger companies and insist that a compliance certificate has to be compulsorily be provided by the Chief Financial Officer of such an investee company. Also the private equity investors generally shielded themselves of any future liability by the appointment of the Chief Executive Officer as the ‘officer in default’ who shall be made liable in the instance of any non-compliance by the company, while the Investor Director nominated by the Board is shielded from any kind of liability.

It has been observed that the finance sector has started to lay huge emphasis on corporate governance especially over the past 5 (five) years and due diligence as a mode of ensuring corporate governance has become extremely significant. One of the private equity investors we interacted with also mentioned that their firm had officially backed out of investment in three companies after it was found that there were many violations on part of these companies in terms of their compliance with certain stamp duty requirements, despite having commercially agreed to investing in the company. In another instance, the private equity investor did not go ahead with investment in a company which dealt with providing security services and with a 40,000 employee count, as it had not maintained a gratuity fund since the past 5 years, and that such non-compliance would directly affect the long term prospects of the company if an employee made a gratuity claim at a later point. Further, it has been established that private-equity funded companies display higher standards of corporate governance than firms that do not receive such funding. This
difference primarily arises from the application of advanced country standards of corporate governance arising from the investors of developed countries that own such private equity funds. Studies have shown that the most common strategies used in practice by private equity firms for achieving this is by the reconstitution of the Board of the investee company, influencing senior executive recruitment and changing the firm’s operating and strategic rules.

As reported by an industry expert, the violations which are usually given prominence by the private equity investors in prospective investee companies are usually analyzed from a business perspective (investors are usually concerned about everything that affects the business value of a company) and the most common violation is that of affiliated transactions not being disclosed (however such non-compliance by the investor has been found to have no forbearance on the valuation of the company) and that usually the domain names and logos are in the name of the founder of the company instead of in the name of the company itself. Also, stamp duty violations are commonly seen in prospective investee companies. However, information made available by a company to an existing shareholder/prospective investor in the public domain also speaks volumes about the levels of governance in a company. The current trend among many of the well managed corporate entities in India is that their Annual Reports disclosed to the public cover relevant information with respect to topics such as governance structure, role taken up by various committees, management personnel; information placed before the board, post board meeting follow-up system, compliance to any non-mandatory recommendations under Clause 49; etc. It is interesting to note that in many annual reports the chapter exclusively relating to corporate governance runs into a large number of pages.

As noted by one of the industry experts we spoke to, a decade back parties investing in private equity funds totally relied upon the management of these entities to make the decision on their behalf as the trust factor ruled very high. Now, it is largely believed that the trust factor goes hand in hand with the requirement of legal compliance being satisfied by a prospective investee company. Also in general, in the private equity market there was a general perception among the investors that conducting legal due diligence prior to investment in a company was leading to a situation where lawyers were being paid huge amounts unnecessarily. To the contrary, both the promoter and the investor are on the same level of emphasis for corporate governance in an entity. The thrust in the private equity industry has been seen to be shifting swiftly from conducting only financial due diligence to extending the scope to include compulsory legal due diligence. However, most of the global investors still continue to discuss only the financials with the private equity investors and trust the private equity investors completely on the non-financial aspects.

As the Audit Committee in any company directly controls the kind of information being divulged to the shareholders, one of the experts we spoke to highlighted the need for strengthening the Committee and noted that further the governance structure in a prospective investee company depends on whether the same is listed or whether it is unlisted. In light of this the expert noted that the aim of private equity investors would be to set ready an unlisted investee company for an intial public offering at a later point. It has been further identified by the expert that an immediate requirement to be fulfilled in order to achieve an investor friendly environment for regulation of unlisted companies with regards to corporate governance is the compliance to a regulation which is not as stringent as Clause 49, but instead a self-developed system that ensures a minimum level of compliance (the industry expert further noted that maximum efficiency can be reached if it is ensured that the reporting system to the Board is adequate) which would be inclusive of complying with minimum requirements such as giving compliance report to the Board every quarter, any relevant reporting compliance to be made to the Reserve Bank of India under the relevant extant guidelines issued by it.

Experts have further identified that the major burning issue with respect to the Indian legal regime which needs immediate attention is the enforceability of commercial contracts. It has been noted that in countries such as the U.S, enforceability of a commercial contract which has been breached is not a complex issue, while in India the enforceability of a contract by approaching the courts is a less effective mechanism. This disadvantage has been reported to be acting as a major deterrent factor for global investors for investing in India and as a result it is seen that most of the investors are choosing Singapore as the venue for arbitration as opposed to pursuing civil litigation for enforcement of contract in India. The failure of the Indian legal system to address investor grievances in a speedy manner has been reported to be affecting the bargaining powers available to the Indian private equity firms with the global investors as companies are increasingly looking at enforcing contracts outside India.

One expert we spoke to has observed that in order to ensure compliance to corporate governance norms by a private equity investor in a prospective investee company, rational investor directors needs to be appointed by the private equity investors on to the board of an investee company. He further noted that such directors need to pose the right questions to the management of the company and that even having a handful number of such directors on the board who pose the right questions can make a huge difference to
corporate governance levels in the company. This measure additionally would be an easy compliance which can be followed by startups. But it is to be awaited and seen as to whether start ups and smaller companies should be subject to a different set of norms to be followed to enable them to opt for raising capital through an initial public offering, as opposed to the ones generally applicable to all companies.

In countries like U.S., private equity players have played a huge role in the corporate governance of companies. Private equity players can contractually impose conditions. Private equity investors can educate investee companies about the benefits of corporate governance without increasing costs. The level of corporate governance insisted by an investor is based on the sector to which the investor belongs and as to whether he is profit driven or governance driven. Hence one solution does not fit all investors. But, it is always good to not replace the management to ensure adequate levels of governance. It is important to note that under the current Indian legal regime there is nothing under the relevant corruption laws which specifically regulate corruption by private entities, but at the same time Indian corporates have been found to possess a lackadaisical attitude with respect to violations they are a party to under foreign corruption laws. Also, in India there is a shortage of Independent Directors in the private equity space, especially the ones who are financially literate. Hence, both these issues need to be immediately addressed if the private equity industry is to expand to its full capacity.

VI. Is the current Clause 49 dynamic with world market requirements?

When Clause 49 was introduced, it was considered as the Indian version of SOX Act and as a most important piece of legislation introducing good governance practices. The current Clause 49 requires the CEO and Chief Financial Officer to accept responsibility for establishing and maintaining internal controls and to evaluate the effectiveness of the company’s internal control systems. Clause 49, however, does not specify the underlying documentation requirements; neither does it recommend an internal control framework against which to benchmark the internal control system. Clause 49 addresses other Board related issues such as number and timing of Board meetings, but at the same time it does not address Board dynamics, the role and responsibilities of the Chairman, the selection process for Non-Executive Directors, director training, and Board procedure, amongst others. On the other hand to effectively address the same Board related issues, the SOX Act requires disclosures regarding off balance-sheet transactions and pro forma figures and mandates accelerated reporting of trading by directors, officers, and principal stockholders. Hence, similar parameters should be expressly incorporated into Clause 49 for ensuring greater transparency in the affairs of a Company.

One of the main concerns regarding Clause 49 has been as to whether it can be completely effective given that the structure of many Indian businesses, where Board members may be reluctant to question leaders of family run businesses. For example, many argue that it is highly unlikely that a Board would ever oust promoters (whose families have been running the companies over many generations). Many experts believe that despite India’s formal governance standards, the fundamental reality of Indian business is that most are still controlled by family shareholders or are government-controlled and hence undermines the effectiveness of these standards.

In January 2013, SEBI issued a consultative paper proposing tougher guidelines for listed companies. SEBI’s proposals seek to bring Clause 49 into line with the proposals made in the Companies Bill, and to impose more stringent regime for listed companies. The consultative paper suggests that independent directors be appointed by minority shareholders and that such directors should be formally trained to be on a company board and regularly evaluated for their performance. Furthermore, to avoid concentration of power in one person’s hands, the regulator has proposed separating the position of Chairman from that of Managing Director of a company. The paper also suggests measures such as rationalizing CEO pay packets, improving compliance for the benefit of small investors, making whistle-blower mechanisms compulsory, and implementing orderly succession planning. Furthermore, to strengthen the monitoring of compliance, SEBI has suggested that Credit Rating Agencies carry out corporate governance rating, and that stock exchanges/SEBI conduct inspections to verify compliance. These proposals, if implemented, would surely bring Indian corporate governance norms up to the highest global standards and make Indian companies more transparent and accountable. Recently it was announced that SEBI was focusing on how to make compliance to corporate governance rules more cost-efficient for companies so that they consider it an investment rather than expenditure; and it would add value both in terms of image and profitability. The Ministry of Corporate Affairs had earlier opined that best practice standards have to be imposed on everyone appropriately and that a debate on whether to put up a uniform corporate governance code for all companies will require the consideration of compliance cost that is required for meeting SEBI norms. However, such compliance cost has to be kept in mind, looking at different levels and sizes of companies. Hence, a step ahead in this direction will be commendable in ensuring effective regulation of private companies operating in India.
VII. Whistle-Blower’s policy in India

One of the key policies in Clause 49 was the whistle-blower policy which was aimed to encourage employees and others, including former employees, or members of an organization, especially a business or government agency, to report unethical or improper practice (not necessarily a violation of law) by approaching the independent Audit Committee without necessarily informing the Board. Clause 49 states that every company should disclose in the corporate governance section of its Annual Report whether a whistle-blower policy is in effect or not, and whether all the employees are granted access to it or not. This disclosure in the Annual Report is mandatory, but framing a whistle blower policy itself is non-mandatory in India. In India, typically, a whistle-blower is governed by an internal company policy which in on-mandatory currently and wherein cases of wrong doing of any kind can be brought to the notice of the top management.

An increasingly positive is emerging in India wherein companies such as India Infrastructure Finance Company Limited, Maruti Suzuki India Limited, and Saint Gobain have drafted and made applicable an exclusive whistle-blower’s policy to their respective organizations. An important aspect of the whistle-blower’s policy under Clause 49 is that the identity of the informer should be kept secret and they must be safeguarded from the unfair termination and other unfair or prejudicial employment practices. But it is important to note that an even more clear policy and procedure for raising issues will help to reduce the risk of serious concerns such as the whistle-blower being mishandled by any insider or by the organization. Dinesh Thakur, the former Ranbaxy director, took home $48.6 million after uncovering the unsafe practices and violations at Ranbaxy in U.S. Legal experts say it is surprising that the official’s name in Ranbaxy was made public since the Witness Protection Programme in the U.S ensures complete secrecy and protection to the whistle-blower. Many times, people are taking a big risk and such cases pose a threat to life and liberty. Even in the US, whistle-blowers tend to get impacted adversely.

It has been found that the success of whistle-blowing to a large extent depends on an organization’s culture. If the leadership is authoritative there is fear and the culture is closed to whistle-blowers. The top management of companies has to encourage whistle-blowers and an independent body needs to examine the case and offer enough support to the whistle-blowers. So the implementation of this policy is gaining traction very selectively and will progress as our overall governance picks up. The lack of proactive regulators and great rewards could be another reason why this policy did not take off in a big way in India. Also, with respect to enforcement against corporate by regulator, the fines levied by Indian regulators are minuscule in comparison to the actual offence. Even when regulators have imposed fines, many of their decisions are challenged in courts, leading to protracted decisions. This is an additional reason that is acting as a deterrent to the effective functioning of whistle-blower’s policy in India.

Hence in India we need a policy which ensures strict anonymity to whistle-blowers and that which allows whistle-blowers to alert government regulatory authorities in the instance of any misfeasance or malfeasance of regulatory norms by a company. It is wiser to incorporate such a whistle-blower policy in the Companies Bill, 2012 so as to encompass even private companies under its ambit and to encourage employees to divulge information which may help in the early detection of a prospective corporate scam.

VIII. Insider trading related law in India

The Galleon Group, one of the world’s largest hedge funds, collapsed following its involvement in an insider trading scandal four years ago and resulted in the conviction of Rajaratnam, and his accomplice Gupta, the trend-setting former head of the management consultancy McKinsey. Rajat Gupta, along with two others was charged for tipping Galleon group’s Rajaratnam with insider information worth billions in one of the biggest hedge fund cases in US history. Rajaratnam and Rajat Gupta were convicted for their participation in insider trading in 2012. This case emphasized the unforgiving nature of securities fraud accusations as the Rajaratnam conviction seemingly reverberated through the courts, leading to strict interpretations of procedural rules attending unrelated insider trading cases.

Throwing light on the corresponding legal framework in India, the SEBI (Prohibition of Insider Trading) Regulations of 1992 requires that a person who is connected with a listed company and is in possession of any unpublished price sensitive information likely to materially affect the price of securities of company, shall not on his behalf or on behalf of any other person, deal in securities or communicate such information to any other person. Accordingly there are certain periodic and continuous disclosures to be made by shareholders of public listed companies to enable SEBI to enable to track any pattern of insider trading. These regulations were amended in 2002. The amendment requires all the listed companies, market intermediaries and advisers to follow the new regulations and also to take steps in advance to prevent the practice of insider trading. The regulations include disclosures, by the directors and other officer, of listed companies and also by persons holding more than 5% of the company’s shares. Insider trading practice is
also required to be curbed during vital announcements of the company. These preventive measures ensure
the reduction of the cases involving the practice of insider trading and also informing the persons who
indulge in such practices of the laws relating to insider trading.

Recently, in India in an action taken against one of the high profile insider trading cases, SEBI fined Reliance
Industries group entity Reliance Petroinvestments ("RPIL") Rs. 11 crore for violating insider trading norms
in the shares of erstwhile IPCL before its merger with RIL.

But India does not have imprisonment related provisions in the instance of non-compliance with the SEBI
(Insider Trading) Regulations, 1992. The insider trading related regime in India can be said to be soft,
wherein the Securities Appellate Tribunal has in the past also held that if a person who had indulged in
insider trading had no intention of gaining any unfair advantage then the charge of insider trading cannot be
sustained.

There should be a regulation introduced to amend the legal framework concerning insider trading in India,
which compels an insider to disgorge or turn in profits made by insiders to the company for any transaction
in equity based securities in the company’s securities (including its parents or subsidiary’s shares) if both the
buy and sell side of the transaction is entered into within six months of the other. Currently, to further make
the insider trading regulations in India more efficient in the context of its specific business environment,
intermediaries in the capital markets like underwriters, lawyers, auditors have been required to comply with
Part B of the first Schedule of the SEBI (Insider Trading) Regulations, 1992. But clearly the regulation of
these other entities is overworked and over regulated at times and operationally impossible at other times.
For instance having a compliance officer who inspects insider trades and grants pre-clearance for trades of
securities of employees is absolutely uncalled for. To give an example practically every law firm advises
listed companies. To have a compliance officer in every firm and monitoring of trades by each employee is
completely unworkable and hence even partial compliance will never happen. This is coupled with penalties
of 10 years in jail, suspension, fines, etc. Hence these ‘corporate governance’ penalties for non corporate
professionals should be removed because adequate remedies are in place for members who are likely to
cause substantial damage by resorting to insider trading.

IX. Need for mandatory forensic audit in India companies

Accounting corporate frauds are the result of manipulation of accounts and accounting jugglery designed to
deceive others for wrongful gains. In all major accounting scandals such as the ones witnessed in the
scandals involving Enron, Worldtel and Parmalat, the methods and purpose of manipulations in financial
statements were peculiar to the motives of such manipulations. Quite often when a company makes losses
in its books, the true picture of the business is much healthier because of the profits in the form of black
money. It is a standard joke among bankers in India that there are many financially sick companies but no
financially sick promoters.

In India under the Companies (Auditor’s Report) Order, 2003, it is required that Auditors Report the
information to as to whether any fraud on or by the company has been noticed or reported during the year.
External auditors look at the numbers but the forensic auditors look beyond the numbers. External Audit is
compulsory by Companies Act, 1956 for every company. The main object of an audit is to go through the
books of accounts. Their job is to find out whether the balance sheet and profit & loss account are properly
drawn up according to Company’s Act, 1956 and whether they represent true and fair view of the state of
affairs of the concern. But forensic auditing is a new concept of investigation. It involves analyzing, testing,
inquiry, and examining the civil and criminal matters and finally giving an unbiased and true report.

"Forensic audit” as a term has not been defined anywhere. On one hand if the concept of financial auditing
may be defined as a concentrated audit of all the transactions of the entity in order to find the correctness
of such transactions and to report whether or not any financial benefit has been attained by way of
presenting an unreal picture, then the concept of forensic auditing aims at the legal determination of
whether a fraud has actually occurred. In the process, it also aims at naming the person(s) involved, with a
view to take legal action. The object of such audit is to relate the findings of audit by gathering legally tenable
evidence and in doing so the corporate veil may be lifted (in case of corporate entities) to identify the fraud
and the persons responsible for it and to find out whether or not true business value has been reflected in
the financial statements and in the course of examination to find whether any fraud has taken place. Fraud
and forensic accounting seems to be the need of the hour which helps in detecting corporate frauds,
arresting business leakages, and to check compliance with the larger corporate governance norms. It is very
penetrative because in order to arrive at the genuineness in the transaction, one has to go to the root of the
transaction and skills in forensic audit to ensure it. Hence forensic audit should be made mandatory in India
for all companies that are running losses and not just those that have essentially been found to have an
improper corporate governance mechanism in place.
It should be remembered that the approach of forensic audit is to unearth evidence of wrongdoing; hence it needs a combined team of people from the police or the Central Bureau of Investigation, lawyers and audit professionals with an adversarial approach. These steps will bring to light frauds, if any, much more quickly, but will not stop them. The Institute of Chartered Accountants of India’s disciplinary board needs to be expanded; and work expedited and publicized to gain public confidence. For large value cases like Satyam, special benches need to be constituted for expeditious decisions. Regaining investors’ and regulators’ confidence should be the highest priority. Given the strategic importance of internal auditors, Companies Bill, 2012 should mandate that internal auditors and valuers must be members of the Institute of Chartered Accountants of India, subject to their professional ethics and regulatory discipline. Additionally, a strong knowledgeable audit committee and its chairman are the best bulwark whenever promoters’ opinion differs from that of the auditors. We should substantially strengthen this system.

X. Need for effective enforcement by regulators

In the high-profile case involving refund of over Rs. 24,000 crore to the bondholders of two Sahara companies, SEBI had passed orders for attachment of various properties and freezing of accounts after the entities failed to deposit the entire money. The regulator has already asked the Supreme Court to allow it to appoint an Officer of Special Duty and other officers to deal with the objections and claims relating to the property to be sold and for conducting the sale of the property to garner funds for refunding the investors’ money. But SEBI has been criticized for its usual delay in taking enforcement actions in many other cases. This is a huge disadvantage to India’s legal system relating to listed entities, as it effectively relies upon public enforcement by SEBI and altogether excludes private enforcement by shareholders, thereby limiting the remedies they can avail. When the Satyam scam came into the public domain early 2009, it was followed by frenetic regulatory action. There were hardly any effective private shareholder actions in India, either by the institutional investors or retail investors. On the other hand, Indian companies such as Infosys and Ranbaxy have been hauled up in foreign jurisdictions for their non-compliance with the domestic laws of U.S. This situation portrays a contrast that exists between the enforcement mechanism of India and largely developed economies like the US.

X. Conclusion

As the face of Indian business is changing, one cannot do business and remain insulated from governance expectations of stakeholders, the customers, investors, and bankers. Simultaneously, governance has to be consistent, constant, and dynamic enough to change and keep pace with a company’s business expectations and markets which they are looking to operate in. So, there is really no choice for a corporation but to comply with the relevant governance norms and as such these norms cannot be applied in a discretionary manner as and when the company desires because they are as integral to the company as the business itself.

As discussed already, the levels of corporate governance in a company has been established to be directly proportional to the investment it is capable of attracting in the long run. The larger compliance set-up to which a company needs to adhere to might remain largely the same over years, while the change in the management of the company might be a more frequent phenomenon. Hence, it must always be remembered that irrespective of who is a part of the management of a company at any given point of time it must be ensured that the management of a company always aims at attaining and retaining high levels of corporate governance in light of the returns it can yield on the long run. But unlike the public sector, the private sector’s transparency is ensured to the stakeholders of the company to a much lesser extent. Hence, we need a complete revamp of the private justice system in India wherein policies such as the whistleblower’s policy should be made mandatory and other governance related policies are enforced more stringently.

It is interesting to note that usually criminals have never been deterred by strong laws and collusive fraud is even more difficult to uncover especially if there is comprehensive paperwork to support it; but, over a period of time, it can be detected by a common sense approach instead of a mechanical approach. As discussed above, in India one of the biggest roadblocks to enforcement of corporate governance is the ineffectiveness of the enforcement mechanism with respect to enforcement of contracts by courts and enforcement of corporate governance norms by regulatory bodies. The delay and lack of seriousness in such enforcement is the pressing need to be addressed by the existing legal regime. The same can be achieved by setting up special courts which look into enforcement of contracts involving any corporate. The judges appointed to hear such matters should be specifically trained to deliver the judgments by keeping the larger market implications affecting the parties in mind and should be financially literate along with having a very sound knowledge of the manner in which such contracts can be enforced effectively. Additionally, regulatory bodies such as SEBI which are very closely involved with the supervision and enforcement of corporate governance norms should ensure that such enforcement and supervision happens in a time...
bound manner and is not restricted to mere statutory compliance of such corporate governance norms by the companies, but in spirit as well. SEBI should report non-compliance or any irregularities by a company to other government enforcement agencies regulating corporations, such as Reserve Bank of India, Income Tax Department, Financial Intelligence Unit, etc which can deal with corporate frauds, as currently there is no mechanism for sharing of such leads, information, and intelligence of one government enforcement agency with another and as a result corporate fraudsters are being let off as the significant warning signs are being missed.