International In-house Counsel Journal
Vol. 2, No. 5, Autumn 2008, 675–686

Corporate Governance
Situation in India as compared to other countries with specific reference to Corporate Governance in US

VIVEK SADHALE
Company Secretary and Head – Legal

VIKAS AGARWAL
Deputy Manager – Secretarial

AMIT ATRE
Assistant Officer – Secretarial

Persistent Systems Limited, India

The views expressed in this Article are strictly the personal views of the Authors

Key Words – Corporate Governance, Clause 49 of Listing Agreement, SOX

Introduction

Corporate Governance is one of the most discussed topics amongst Corporates today. The decade of 1990s could be remembered with the buzzword of 'Corporate Governance'. It is a set of principles that expects the business houses to run their business with the equal justice with the separation of ownership and management along with compliance of other Acts and rules applicable to the companies. While Corporate Governance is not a new concept, it will keep evolving to keep pace with the changing business environment.

Corporate Governance is an inclusive terms that reaches to the masses through the operations of the company and its stakeholders. Appointment of a Managing Director / CEO in a company is a subject matter of Corporate Governance. At the same time, statutory defaults made at a company's branch would also is a subject matter of Corporate Governance. Corporate Governance principles extend to all the corporates, small or big, across the world.

Corporate Governance can be defined as a set of processes, policies, laws and institutions affecting the way a corporate is directed, administered and controlled. The principle stakeholders in the Corporate Governance are shareholders and the Board of Directors. The other stakeholders include employees, suppliers, customers, bankers, lenders, regulators and the community at large.

Key elements of good Corporate Governance principles include honesty, trust, integrity, openness, performance orientation, responsibility, accountability, mutual respect, and commitment towards the organization. The principles of Corporate Governance are same principles that are followed for ages while running a business considering the common interest of the society. The novel part of these principles is recognition of these principles by country specific laws.

The Corporate Governance code first emerged in the United Kingdom through the work of Sir Adrian Cadbury Committee. Cadbury Code, a code of best practice, served as a basis for reform of Corporate Governance around the world and since then, a series of thoughts and reports were published by various authorities according to the priorities decided by their institutes / countries.

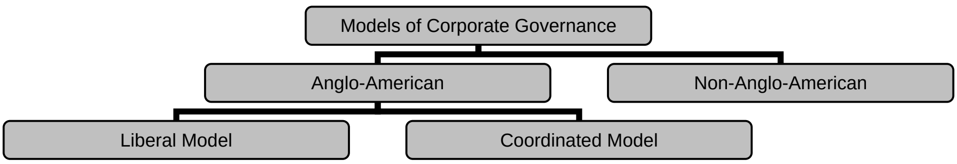
The major success of UK efforts in implementing Corporate Governance was that the Cadbury Code report's recommendations have been adopted in varying degree by the European Union, the United States, the World Bank, and others.

Organisation for Economic Co-operation and Development (OECD) principles of Corporate Governance, Greenbury Committee on Directors Remuneration, Hampell's Committee on the Corporate Governance stressing on Directors' remuneration, stakeholders' interest and the accountability and King's Committee of South Africa highlighting best practices on the Board issues, financial reporting, transparency and audit are a few other examples how the committees differ their stress on the various principles of Corporate Governance.

The aforesaid Codes of Corporate Governance are further based on the two models of the Corporate Governance around the world. The basic difference between these models is the level of capitalism in which they are embedded.

1. Anglo-American Model

2. Non-Anglo-American Model



Anglo-American Model is also regarded as the Shareholders' Wealth Maximisation (SWM) Model. This model is further divided into two models by it's followers viz. Liberal Model and Coordinated Model.

Liberal Model from the Anglo-American Model is common in Anglo-American countries that tend to give priority to the interests of shareholders. The common examples of the Liberal Model are the Codes established in the USA and UK. The Coordinated Model can be found in Japan, Europe which recognizes the interest of workers, managers, suppliers, customers and community. These countries are developed economies and have ample opportunities to search for new facets of Corporate Governance than to concentrate on its basic principles.

This Liberal Model encourages radical innovation and cost competition whereas the Coordinated Model facilitates incremental innovation and quality competition. Both Models have distinct competitive advantages but are relevant in different economies.

Non-Anglo American Model, which is commonly called as Corporate Wealth Maximisation (CWM) Model, is all together different from these capitalistic economic outcomes. Most of the countries in the East Asian countries are developing countries. Most of these countries are either socialistic or are recently turned on the way to the capitalism. These countries are experiencing the revolution in the business and political relationship that characterizes the private and public companies. Obviously, the expectations from the Corporate Governance differ.

The Corporate Governance Codes emerging in these counties are based on the following four requirements:

1. Improving quality of the information and increasing the speed of its distribution to the public;
2. To allow more autonomy to individuals with enough time keeping and accountability;
3. Good hierarchical organization that defeats the evils of private companies; and
4. States' role in regulation and selection of capable government officials.

As we can see, the different regions have different priorities for setting their Corporate Governance Codes. The stress on the different Corporate Governance principles becomes country specific. It would be interesting to know different practices that are followed worldwide in comparison with the Corporate Governance Code in India i.e. Clause 49 of the Stock Exchange Listing Agreement.

To begin with, let us consider the Corporate Governance Code established in USA, World economy giant with the Corporate Governance Code in India.

Background:

The need for the strong Corporate Governance Code in India was the Asian Financial Crisis or commonly known as IMF crisis in July 1997. This crisis which started in Thailand, soon spread in South-East Asia and Japan in the form of fall in currencies, devaluation of the stock markets and asset prices, and a steep rise in debts. A thought was forwarded that proper system for early recognition and a periodical check on the market position could reduce the impact of this crisis. This crisis forced the Asian countries to think on an organised framework such as Corporate Governance.

In India, the Confederation of Indian Industries (CII) took initiative and published first-ever attempt to codify corporate governance best practices for India in April 1998. Though it was a commendable attempt to codify the Corporate Governance practices for India, it remained as a recommendatory because of the institutional framework of CII. However, the process got started.

CII effort was followed by the mighty effort of the Indian Securities Market in the form of Kumar Mangalam Birla Committee on 'National Code on Corporate Governance' in 1999. Upon the recommendation of this Committee, the Securities and Exchange Board of India (SEBI) introduced Clause 49 into the Listing Agreement of the Stock Exchanges in the year 2000. This is popularly known as the Corporate Governance Clause.

On the contrary, in US, the emergence of Corporate Governance cannot be linked to the specific year. The principles became popular in US after successful implementation of Corporate Governance – Cadbury Code in UK. The main reason for this was the manner of introduction of Corporate Governance Code in the form of amendments in the existing systems and legal framework of US.

Securities and Exchange Commission (SEC), New York Stock Exchange (NYSE) and NASDAQ that mainly govern the US listed companies incorporated the customised Corporate Governance Code. Both federal and unitary levels in US have their own body of corporate law governing corporations. NYSC, NASDAQ and rest of the stock exchanges have their own set of corporate governance rules. One may conclude that the

Corporate Governance in the US has multiple applicability and one needs to identify the applicable rules to particular company very carefully.

Over a period, after well-documented collapses of high-profile corporations such as Enron, Xerox and World Com, the SEC, being the prime monitoring body in US felt the need to review their regulatory framework on an overall US Security Laws.

Priorities of the market changed from ‘disclosure and minimum procedures’ to ‘set of substantive rules that were more familiar in the Civil Code tradition. The focus shifted from simplicity and auto-regulated capitalistic society to sharper accountability and responsibility and to leave less room for managers, directors and auditing firms to distort or misrepresent a company’s performance. This once again highlighted the importance of Corporate Governance Code. The Economists concluded that the collapse of big corporates was reflection of the position of stakeholders in the Securities Market and the future of self-regulated capitalistic societies. On this background, there was a rise in reforms in the Securities markets to repose the investors’ confidence.

The situation was similar to the Securities Scam in India in 1992. At that time, the common investors and other stakeholders in Securities markets in India were going from the same pain.

The big day in US corporate history was, July 30, 2002, when the Sarbanes – Oxley Act, 2002 (the SOX) was promulgated. SOX affected the Securities Exchange Act, 1934 and the related legislations to a large extent. The major objective of framing of SOX was to regain the investors’ confidence and to impose harsher restrictions on the public companies that were directly relating to investors’ monies and confidence.

One of the major steps in SOX was establishing Public Company Accounting Oversight Board (PCAOB). PCAOB is a private sector, non-profit corporation with main responsibilities defined by their ministry.

USA is one of the major players in the world economy and hence, the implementation of their best practices obviously affected on the Indian Corporate Governance Code. Ministry of Corporate Affairs (erstwhile Department of Company Affairs) had set up the different committees under the chairmanship of:

1. Mr. Naresh Chandra, former Cabinet Secretary (Chandra Committee) to highlight role of auditors, certification by CEO and CFO and the definition of independence of a director;
2. Mr. N. R. Murthy, Chairman, Chief Mentor and Founder Director of Infosys Technologies Limited, India (Murthy Committee) to evaluate the adequacy of existing corporate governance practices and further improve these practices; and
3. Dr. J. J. Irani, Executive Officer, Tata Sons to give a report with recommendations for a comprehensive revision of the Companies Act, 1956 and best practices that the companies can implement.

Comparative Analysis of Corporate Governance Code in India and US

1. Board Structure:

US and India have a unitary structure of Board of Directors where all directors stand on equal footing and are legally responsible for managing the company's business. However, recently Dr. J. J. Irani Committee on Companies Act, 1956 has expressed opinion on differentiation in the liabilities of the Directors as per their involvement in the decisions of the Board.

2. Role of Board of Directors:

US is seen to be liberal while deciding the role of the Directors as a brief note on the role of the Board can be seen in the US laws whereas India has a detailed role in respective laws.

Following is the role of the Board of Directors of US companies:

a. To select, evaluate and compensate the Chief Executive Officer (CEO);
b. To debate and ultimately approve the company's strategy;
c. To ensure that the company is managed in the best interest of its shareholders; and
d. To oversee the auditing process resulting in the proper disclosure of accurate financial statements.

Birla Committee in its report reveals the Board's role in the parts of Direction and Control as follows:

1. By direction, Directors are responsible for,
   i. formulating and reviewing the company's policies, strategies, major plans, setting performance objectives;
   ii. monitoring implementation and corporate performance;
   iii. overseeing major capital expenditures, acquisitions and divestitures, change in financial control; and
   iv. compliance with applicable laws, taking into account the interest of stakeholders.

2. By control, Directors are responsible for
   i. laying down the code of conduct;
   ii. overseeing the process of disclosure and communications;
   iii. ensuring that the appropriate systems for financial control;
   iv. reporting and monitoring for keeping the risk in place;
   v. evaluating the performance of management, chief executive, executive directors; and
   vi. providing checks and balances to reduce potential conflict between the specific interests of management and the wider interests of the company and shareholders including misuse of corporate assets and abuse in related party transactions.

3. Composition of the Board of Directors:

In US, neither SEC nor any federal legislation has rules on board size and therefore number of directors varies significantly from company to company. However, individual stock exchanges such as NYSE have determined that listed companies must have majority of independent directors.

In India, Clause 49 determines the Board composition based on the Chairperson of the Board

i. If Chairperson is an executive Director, more than 50% directors on the Board should be Independent Directors
ii. If Chairperson is a non-executive Director, more than 33% directors on the Board should be Independent Directors.

4. Independence of the Directors:

The word independence is subject matter of the present and past monitory relationship of a person with company, its management and the executive directors. This is mainly to identify the monitory dependence of the non-executive directors on the company and the possible effect of such relationship on the decision making power of that director. As the intention of the term independence is reducing dependence on the company, these definitions are mostly negative while determining the independence of a person as director.

In USA, independence of the Directors is defined in the NYSE Stock Exchange rules. NYSE Corporate Governance Rules as approved by SEC states that listed companies must have independent directors. The rules proceed with tightened definition of directors' independence as follows:

1. A Director must not have material relationship with the listed company, directly or as a partner, shareholder or office of an organization that has a relationship with the company.
2. A Director or any of the immediate family members should not be an employee or an executive officer or was not in employment or as an executive officer until three years after end of such employment relationship.
3. A Director who or an immediate family member who receives more than US$ 100,000 per year in direct compensation from the listed company other than the Director / Committee fees and pension or any such deferred compensation for prior service is not an independent until three years after he / she ceases to receives compensation as above.
4. A director / immediate family member of such Director affiliated or employed in a professional capacity by a present or former internal or external auditor of the company is not independent until three years after end of the affiliation or the employment or auditing relationship.
5. A Director / immediate family member of such Director is employed as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee is not 'independent' until three years after the end of such service or the employment relationship.
6. A Director / immediate family member of such Director is an executive officer of a company that makes payment to or receives payments from the listed company for property or services in an amount which in any single fiscal year, exceed the greater

of US$ 1 Million, or 2% of such other company's consolidated gross revenues, is not 'Independent' until three years after falling below such threshold.

The Sarbanes-Oxley Act, 2002, prescribes additional clauses as prohibition for independence of the Audit Committee members:

1. Accept any consulting, advisory, or other compensatory fee from the issuer; or
2. Is an affiliated person of the issuer or any subsidiary thereof.

In India, Naresh Chandra Committee in 2002 emphasized the point that directors are fiduciaries of shareholders and not the management; and should be expected to exercise "Independent Oversight Judgment."

The concept was incorporated with recommendations of Narayan Murthy Committee in 2003 with some minor revisions.

In terms of Clause 49 of the Listing Agreement, 'independent director' shall mean a non-executive director of the company who:

a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;
b. is not related to promoters or persons occupying management positions at the board level or at one level below the board;
c. has not been an executive of the company in the immediately preceding three financial years;
d. is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:
    i. the statutory audit firm or the internal audit firm that is associated with the company, and
    ii. the legal firm(s) and consulting firm(s) that have a material association with the company.
    iii. is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director.
    iv. is not a substantial shareholder of the company i.e. owning two percent or more of the block of voting shares.
    v. is not less than 21 years of age.

5. Terms of Service of Directors:

In US, there are no specific provisions defining the term of a Director to serve on the company, neither mandatory nor recommendatory. Whereas, in India, it is recommended that the Non-executive Directors should serve as independent directors in any company not more than nine years.

6. Committees under Corporate Governance:

To confirm the best delivery of the judgement and the benefit of individual capacities of the directors, both nations recognise the concept of sub-committees. US and India have three committees that are mandatorily formed under Corporate Governance Code.

US Corporate Governance Code requires the companies to form following committees:

1. Audit Committee
2. Nominating / Governance Committee
3. Compensation Committee

Whereas, Corporate Governance Code under Clause 49 requires Indian listed Companies to form following committees of the Board:

1. Audit Committee
2. Shareholders' / Investors' Grievance Committee
3. Remuneration Committee

It is interesting to note that most of the terms such as composition and scope of the Audit Committee are common in India and US. Corporate Governance Code in India does not define specific constitution of above committees. It only guides the companies about the minimum requirement for the composition and the overall scope of above Committees.

Compensation Committee in India and Remuneration Committee in US have similar agenda that is to monitor the remuneration to the executive directors of the company. This ensures the characteristic of forming a company – separation of ownership and management.

Indian Corporate Governance Code requires the companies to form a Shareholders' / Investors' Grievance Committee, which as its name suggests, exclusively takes care of the grievance relating to shareholders / investors being the owners of the company. The companies are required to disclose the periodic summary of the nature of complaints received, status of the complaints and the reasons, if any if a particular compliant is pending for long time. Even the stock exchanges are particular in reducing the shareholders / investors related grievances.

Under the Corporate Governance code in US, constitution of Nominating Committee is compulsory which is responsible for the restructuring of the Board of Directors and recommending to the Board for better output from the Board as a resource team. This Committee is even responsible for the review of individual as well as group performance of the Directors on the Board and recommendation on continuation of any directors on the Board of Directors of the company. This ensures the performance guarantee from individuals.

The trend of voluntary implementation of the better Corporate Governance norms is increasing in India as well. Most of the big corporate houses have set their Nominating Committees on the ground of practice abroad. This is mainly due to the nature of the Corporate Governance that can be customised by the business houses according to their individual needs.

Latest issues in the Corporate Governance:

In US:

1. Executive Compensation:

In the last few years after the financial and accounting scams in 2002, the importance of Audit Committee, politicians and the press has tremendously increased. This has direct impact on the executive compensation that is to be disclosed as a norm of Corporate Governance. Corporates are struggling to explain the basis of compensation offered to the executives of the company.

2. Shareholders activism and majority voting:

The trend is changing in the US as far as voting at the general meetings is concerned. Formerly, the companies were getting benefits of plurality voting i.e. single-winner voting system, which is based on single-member constituencies. However, now a days, shareholders activism is demanding simple majority voting where, they are given two options, the option receiving a simple majority of votes wins, a well-known example of democratic procedure. Though the companies are accepting the shareholders' say, this poses many questions before the management while managing the affairs of the company on day-to-day basis.

3. Director recruitment:

In US, constituting a Nominating Committee is a pre-requisite for listing of companies, because, identifying the right candidate on the Board who will be fit in the requirements of the company is a very important decision.

4. Splitting the roles of chairperson and CEO:

There is a growing trend in US that the Chairperson and the Chief Executive Officer should not be the same. The question is asked on the balance of statutory and fiduciary duties of a Chairman of the Board and CEO of the company if both are same person. Company managements have to consider both the views and express their actions on the Board structures in acceptable form to its shareholders.

5. Focus on strategy and succession:

In recent years, the main focus of a board's work has been on the fine-tuning the strategies of the companies with special consideration of the long run. Now a days, the companies are taking strategic approach to board composition, giving careful consideration to succession planning for the CEO, the senior executive team, and the board itself.

In India:

1. Directors Independence:

Independence of an individual is a key issue amongst the corporates. The limited number of independent qualified persons that suit the requirements of the industries and the companies is a big challenge for the corporates. The industry bodies such as CII, NASSCOM, MCCIA and professional Institutes are offering the database for the Independent Directors.

2. Role of Independent Directors:

There is an expectation mis-match identified in most of the appointments of Independent Directors. Due to expectation mis-match between the Independent Directors and the individual styles of the companies and their promoters, there is often a question on the effective functioning of the independent directors.

3. Remuneration to independent Directors:

Considering the scarcity of the qualified independent directors and the requirement for Independent directors on the board, there is no standard for determining the remuneration of the independent directors. As per one school of thought, independent directors should not be dependent on the earnings out of their directorships. The directors are appointed to serve the company in their independent capacity. As per other school of thought, the independent directors must be adequately compensated for their effort, time and interest considering their knowledge and position.

It is observed that some companies are paying substantial fees to attract and retain the right people as Independent Directors on their boards.

Conclusion:

The study of the overall comparison Corporate Governance Codes of US and India reveals that most of the practices of the Corporate Governance are common. The difference is the approach of the regulators and support of the stakeholders in implementing the same. The role of monitoring agencies such as SEC and SEBI would be very crucial in coming days.

From Indian perspective, initiatives of Corporate Excellence awards, ranking of investors' friendly companies, promotion of voluntary implementation of Corporate Governance practices at institutional levels would definitely help Indian companies to march forward.

Bibliography:

1. Governance Lexicon 2007 - Spencer Stuart publication

2. Wikipedia –
   http://en.wikipedia.org/wiki/Corporate_governance
   http://en.wikipedia.org/wiki/First-past-the-post
   http://en.wikipedia.org/wiki/Majority_voting

3. Journal on World Business –
   http://www.sciencedirect.com/science?_ob=ArticleURL&_udi=B6W5M-49M6DH5-6&_

Vivek Sadhale is a Company Secretary and Head – Legal of Persistent Systems Ltd., one of the leading outsourced software product development company with a turnover of about US$ 105 Mn. and 4,000+ employees.

Mr. Sadhale has more than twelve years of hands-on experience in Corporate Secretarial, Corporate Governance, Corporate Legal matters and Management Accounting, with exposure to Finance and Treasury functions with reputed Indian and Multinational organizations.

His expertise spreads over numerous fields including top tier venture capital and private equity funding, M&A/takeovers, joint venture agreements and preparation for Initial Public Offer. He has contributed significantly in establishing domestic/overseas offices and companies, designing Employee Stock Option schemes, negotiating foreign currency loans, dealing with IPR-related issues and international commercial contracts.

Mr. Sadhale has a flair for teaching and writing, and has contributed various articles in leading professional journals, newspapers and souvenirs published at national and international conventions. He is also a visiting faculty at various business schools, professional institutes and law colleges.

He is an elected member to the Managing Committee of Western India Regional Council of Institute of Company Secretaries of India (ICSI) for 2007-2010. He was earlier part of the Managing Committee of Pune Chapter of ICSI for 2004-06. He is also a founder member of Pune Chapter of Technology Law Forum – an initiative of NASSCOM.

Mr. Sadhale is a recipient of "Suryadatta IT Excellence Award" in the category of Best CFO / Company Secretary for the year 2005.

A Commerce and Law graduate, he completed his Chartered Secretaryship from UK, and is a Company Secretary and Cost and Works Accountant from India. Mr. Sadhale has a distinction of passing all professional exams in first attempt and qualified as a cost accountant along with B.Com.

Mr. Vikas Agarwal works with a leading software company, Persistent Systems Limited as Deputy Manager – Secretarial handling corporate secretarial matters. He has more than seven years experience in corporate secretarial, corporate governance, corporate laws with specific relating to mergers, preparation for the Initial Public Offer, setting up of domestic / overseas companies and branch offices, drafting of ESOP Schemes, formation of export oriented undertaking, STPI unit, special economic zone unit and managing IPR related issues.

Mr. Agarwal is the faculty for various training programs conducted by the Pune Chapter of the Institute of Company Secretaries of India (ICSI). He is also a visiting faculty at Law College in for company law.

Mr. Agarwal is an elected member of Managing Committee of Pune Chapter of Western India Regional Council (WIRC) of ICSI for the term 2007-2010 and presently holds the position of Treasurer at Pune Chapter. He is the Chairman of the IT Committee of the Pune Chapter and a member of IT Committee of WIRC of ICSI.

Mr. Agarwal has authored articles in premier professional journals like Chartered Secretary, SEBI and Corporate Laws, Focus, Chartered Accountants Today, Chartered Accountants Professional Journal, Sanhita and various leading newspapers like Economic Times, Times of India, Indian Express, etc. He has jointly won the Best Article award for four consecutive years for the articles published in Sanhita, monthly publication of the Pune Chapter of ICSI.

Mr. Agarwal is a qualified Company Secretary and a Commerce Post-Graduate.

Amit Atre is the Assistant Officer – Secretarial at Persistent Systems Ltd., one of the leading outsourced software product development company with a turnover of about US$ 105 Mn. and 4,000+ employees.

Mr. Atre has more than two years of experience in corporate secretarial matters.

Mr. Atre is a visiting faculty and a guest lecturer at a reputed professional institution. He is a member to the Students' Committee of the Pune Chapter of the Institute of Company Secretaries of India (ICSI) for 2007-2009.

A Commerce and Law graduate, he is a Company Secretary from India. Mr. Atre ranked first in the International course on 'IPR and e-commerce' held by WIPO in 2006.