1. **Subject Name: Business Ethics**
2. **Semester / Year: Second (Semester II)**
3. **Name of the Teacher: Pinaki Dey**
4. **Name of the topic: Corporate Governess (Part II)**

19.7 COMMITTEE REPORTS ON CORPORATE GOVERNANCE

- Corporate governance has received widespread recognition due to the constitution and formation of various committees and formulation of various laws throughout the world.
- A ***Corporate Governance Report*** is a written document prepared by an organization or a government-authorized body, constituted specifically to lay down the framework for creating long-term trust between companies and the external providers of capital.
- Although there have been several committee reports over the course of the last few decades, there are few common aspects that are highlighted in the major ones. Companies around the world are appreciating that:
  - Better corporate governance adds considerable value to their operational performance
  - The importance of corporate governance does not lie solely in generating better access of finance

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1 **Insider trading** refers to the trading by shareholders who hold private inside information that materially affect the value of their stocks and allows them to benefit from buying or selling stocks.

- Strategic thinking is bettered at the top by inducting independent directors who bring a wealth of experience, and a host of novel ideas
- The management is rationalized and global risk faced by firms are monitored carefully
- The liability of the top management and directors is limited by carefully articulating the decision-making process

19.7.1 Corporate Governance Reports and Acts Outside India

- Corporate governance has received widespread recognition due to the constitution and formation of various committees and formulation of various laws throughout the world.
- The foundation of the contemporary developments in the corporate governance framework can be traced to the Treadway Commission (1985), USA, to combat corporate fraud and develop integrated guidance on internal control.
- The evolution of corporate governance with reference to the various *relevant committee reports on corporate governance in the global context* has been highlighted as follows:
  - **The Cadbury Report, United Kingdom (1995):**
    - The objective of the Cadbury committee was to investigate how corporate governance guidelines should be adopted and integrated by large public companies.
    - Some of the major issues highlighted by the committee included the role played by the board of directors, financial reporting standards of, accountability of the auditors and pay provided to directors of the company.
  - **The Greenbury Report, United Kingdom (1995):**
    - The report focussed on the remuneration of executive and non-executive board members.
    - It recommended the establishment of a remuneration committee and a remuneration policy in each public company to determine remuneration packages for the board members.
  - **The Hampel Report, United Kingdom (1998):**
    - The report sought to combine, harmonise and clarify the recommendations provided by the Cadbury and Greenbury Committees.
    - Four major issues were focussed upon and concrete guidelines were offered with reference to the role of directors, the compensation of directors, the role of shareholders, and accountability and audit.
  - **The Turnbull Report, United Kingdom (1999):**
    - The report focussed on reminding directors about maintaining good 'internal controls' in their companies.
    - It also focussed on ensuring good audits and checks to ensure the quality of financial reporting and arrest any fraud before they turn into problems.
  - **The Sarbanes–Oxley Act, United States of America (2002):**
    - It is a federal law that set new or expanded requirements for all U.S. public company boards, management and public accounting firms, in light of the major corporate scandals in the U.S., involving Enron, WorldCom, and Tyco.
    - It covers key governance aspects such as auditors independence, corporate responsibility, enhanced financial disclosures, corporate and criminal fraud accountability, while collar crimes, corporate tax returns, corporate fraud accountability etc.

- **Keeping the Promise for a Strong Economy Act (Budget Measures), Canada (2003):**
  - Also known as Bill 198 or the Canadian Sarbanes–Oxley Act, it was principally the same as its American counterpart, but varied in its accountability and execution.
  - It required companies to deliver a reasonable assurance of preventing risk of material misstatement, and show high levels of commitment, care and meticulousness for reviewing and documenting their internal controls.
- **The Higgs Report, United Kingdom (2003):**
  - The report examined the role and effectiveness of non-executive directors as well as that of the audit committee.
  - It aimed at improving and strengthening the existing UK Corporate Governance Code.
- **The Smith Report, United Kingdom (2003):**
  - The report focussed on the independence of auditors in the wake of the collapse of Arthur Andersen and the Enron scandal in the USA in 2002.
  - It specified that an auditor should himself look at whether a company's corporate governance structure provides safeguards to preserve his own independence.
- **OECD Principles of Corporate Governance (2004):**
  - It refers to those principles, which helps governments in improving the legal, institutional and regulatory framework that underpins corporate governance and ultimately helps preserve financial and economic stability.
  - These principles sought to ensure six aspects, namely, the basis of an effective corporate governance framework, the rights of shareholders and key ownership functions, the equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency, and the responsibilities of the board.
- **International Finance Corporation and the UN Global Compact Report (2009):**
  - It prosed ten principles, that linked the environmental, social and governance responsibilities of a company to its financial performance and long-term sustainability.
  - The report recommended companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labour standards, the environment, and anti-corruption.
- **The Dodd–Frank Act, United States of America (2010):**
  - It is a federal law that places the regulation of the financial industry in the hands of the government.
  - The legislation, which was passed in response to the 2008 global financial crisis, created financial regulatory processes to limit risk by enforcing transparency and accountability.

19.7.2 Committee Reports on Corporate Governance in India

- Corporate governance in the Indian context is relatively new. In 1995, the Confederation of Indian Industries (CII) had instituted a task force under Rahul Bajaj, and came up with a voluntary code called 'Desirable Corporate Governance' in 1998.
- On October 29, 2004, SEBI (Securities and Exchange Board of India) issued a modified ***Clause 49***, which became operational on January 1, 2006. The term 'Clause 49' refers to clause number 49 (out of 54 clauses) of the Listing Agreement[2] between a company and the stock exchanges on which it is listed.

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2 **Listing** refers to the admission of securities for dealings on specified stock exchanges. Companies interested in getting their securities listed are required to enter an agreement with the Exchange called the Listing Agreement and are required to make certain disclosures and perform certain acts in an ethical manner.

The norms pertaining to corporate governance for Indian listed companies are presented in this Clause 49 of Companies Act, in the listing agreement.

- The goal of the various legislations, regulations and committee reports is to develop a transparent, ethical and responsible corporate governance framework in India. Some of the key committees are highlighted as follows:
  - **CII Voluntary Code of Corporate Governance (1998):**
    - It has been the forerunner of the corporate governance framework in India, and was the first unique instance where an industry association took the lead in prescribing corporate governance standards for listed companies.
    - It provided a list of voluntary recommendations with reference to the best practices of corporate governance for listed companies
  - **Kumara Mangalam Birla Committee (1999):**
    - The mandatory recommendations of this committee include the constitution of Audit Committee and Remuneration Committee in all listed companies, along with the appointment of one or more independent directors in such companies, the obligation to make more disclosures in annual financial reports, effective use of the power etc.
    - The committee made several non-mandatory recommendations with reference to the role of the Chairman, remuneration committee of board, corporate restructuring etc.
  - **Narayana Murthy Committee (2002):**
    - The key mandatory recommendations focus on strengthening the responsibilities of audit committees, improving the quality of financial disclosures, including those pertaining to related party transactions and proceeds from initial public offerings, improved disclosures relating to compensation paid to non-executive directors etc.
    - The non-mandatory recommendations include moving to a regime where corporate financial statements are not qualified, instituting a system of training of board members, and the evaluation of performance of board members.
  - **Naresh Chandra Committee (2003):**
    - The Naresh Chandra Committee was appointed as a high-level committee to examine various corporate governance issues by the Department of Company Affairs.
    - The committee's recommendations concerned issues such as the auditor-company relationship, disqualifications for audit assignments, list of prohibited non-audit services, independence standards for consulting etc.
  - **Clause 49 of the Listing Agreement (2005):**
    - Some of the mandatory provisions of the agreement are composition of board and its procedures in terms of frequency of meetings, number of independent directors, code of conduct for the board and senior management etc. as well as audit committee, its composition, and the role provisions relating to subsidiary companies.
    - The non-mandatory recommendations constitution of remuneration committee, training of board members, peer evaluation of board member etc.
  - **J.J. Irani Committee (2005):**
    - This committee made recommendations on responses received from various stakeholders on the concept paper, issues arising from the revision of the Companies Act, 1956, enabling easy and unambiguous interpretation by recasting the provisions of the law, protecting the interests of the stakeholders and investors, including small investors etc.

- **Companies Bill (2009):**
  - Also known as, the Standing Bill for Finance, the Companies Bill provides the basic principles for internal governance aspects of corporate entities and a framework for their regulation, from incorporation to liquidation and winding up, in a single, comprehensive and legal framework to be administered by the Central Government.
  - The Bill seeks to harmonise the company law framework with the sectoral regulations.
- **Ministry of Corporate Affairs Corporate Governance Voluntary Guidelines (2009):**
  - These recommendations are purely voluntary in nature and calls for partial participatory approach to combat contemporary corporate governance issues in India.
  - Some of the important recommendations of Voluntary guidelines include appointment of the director, independent director, including their remuneration and the responsibilities of the board.
- **NASSCOM Corporate Governance Recommendations (2009):**
  - This was the first appointment of a committee by an IT industry body, which took place because the fraud and governance failures at Satyam Computer Services put the credibility of the IT/BPO industry in India at stake.
  - A distinctive feature of the NASSCOM (The National Association of Software and Services Companies) recommendations is that they focus heavily on the protection of stakeholders in a company such as customers, employees, other partners such as vendors, and even competitors, which is a marked departure from previous governance reform measures that focus almost solely on protection of shareholder interests.
- **Kotak Committee on Corporate Governance (2017):**
  - The primary objective of this committee was to improve standards concerning corporate governance of listed companies in India, and was represented by different stakeholders, including the government, the industry, stock exchanges, academicians, proxy advisors, professional bodies, lawyers, etc.
  - The Committee was required to provide recommendations on diverse issues such as ensuring independence in spirit of independent directors and their active participation in the functioning of the company, and improving safeguards and disclosures pertaining to related party transactions.

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Summary of Revised Clause 49 of SEBI Listing Agreement

The SEBI has replaced the existing Clause 49 of the Listing Agreement with a revised Clause 49 (referred to as the 'New Clause'). The New Clause, which was effective from October 1, 2014, served the objectives of aligning the provisions of Listing Agreement with the provisions of the newly enacted Companies Act, 2013 and providing additional requirements to strengthen the corporate governance framework for listed companies in India. The key provisions in Clause 49 and Companies Act, 2013 may be summarized as follows:

- **Independent directors:** The New Clause confers greater power and responsibility on the independent directors to on matters relating to corporate governance. Some of the key changes in respect of the independent directors are summarized below:
  - **Tenure**: The New Clause restricts the total tenure of an Independent Director to a two terms of 5 years each. Further, if an independent director has been completed his total tenure, he shall be eligible for reappointment only after a period of three years.

FACT FILE

- **Restriction on the number of boards independent directors can serve:** An independent director can serve on the boards of maximum seven listed companies If such person is serving as a whole time director in a listed company, then he cannot be serve more than three boards of listed companies.
- **Separate meeting of independent directors:** Independent directors shall conduct a separate meeting at least once in year. A separate meeting without the presence of the management/ executive directors provides them an opportunity to express their opinion freely and independently.
- **Performance evaluation:** It is mandatory to conduct the performance evaluation of the independent directors, which shall be done by the whole board except the directors being evaluated.
- **Prohibition of stock option:** In line with the Companies Act 2013, the New Clause makes it clear that the independent directors are not entitled to any stock option or any pecuniary interest in the company apart from the director's remuneration.
- **Exclusion of nominee directors from the definition of independent director:** The nominee directors have a definite mandate of safeguarding the constituency they represent, which are generally the lenders of the company. Hence, including them with in the pool of independent directors may be inappropriate for the overall corporate governance of the Company, and hence, they are excluded from the definition of independent directors.

- **Related party transactions (RPT):** The New Clause provides that all material RPT requires prior approval of the shareholders through a special resolution and the related parties are prohibited from voting such resolutions. They also have to be disclosed in the quarterly compliance report on corporate governance.
- **Subsidiary company:** The New Clause extends certain principles of corporate governance to material subsidiaries[3] of listed companies. The Clause mandates that at least one Independent Director on the board of the holding company shall be a director on the board of the material non-listed Indian subsidiaries also. Further, no company shall dispose of shares in its material subsidiary, which would reduce its shareholding to less than 50 percent or cease the exercise of control over the subsidiary without passing a special resolution in its general meeting.
- **Expanded role of audit committee:** The Clause requires Audit Committee to have minimum three directors as members and two-third of members shall be independent directors. The Audit Committee has been given a significant role regarding the appointment and monitoring of auditors, financial reporting of the Company, monitoring inter corporate loans, RPTs, reviewing the functioning of the whistle blower mechanism, etc.
- **Compulsory whistle blower mechanism:** The New Clause makes it mandatory for companies to establish a vigil mechanism to enable directors and employees to report unethical behaviour and frauds. The mechanism should also provide adequate safeguards to prevent victimization of the whistle blower.
- **Nomination and remuneration committee:** The New Clause makes it mandatory for companies to set up a Nomination and Remuneration Committee to formulate criteria for determining qualifications, positive attributes and independence of a director and recommend a policy relating to the remuneration of the directors, key managerial personnel and other employees.
- **Other requirements:** The Clause requires the board of directors to form a code of conduct and strict compliance with such code. They shall be responsible for framing, implementing and monitoring the risk management plan for the company. The Company shall also constitute a risk management committee. In line of the Companies Act 2013, the Clause mandates representation of at least a single woman director in the board.

3 A material subsidiary is defined as a subsidiary whose income or net worth exceeds 20% of the consolidated income or net worth, as the case may be, of the listed holding company.