Investors seek improved corporate governance

By Priti Suri and Neeraj Dubey, PSA Legal Counsellors

PSA
Legal Counsellors
E-601 Gauri Sadan, 5 Hailey Road
New Delhi - 110 001, India
Tel: +91 11 4350 0500
Fax: +91 11 4350 0502
Email: p.suri@psalegal.com

In an emerging market like India, investors require the assurance that the companies in which they are investing are managing their human, physical and financial resources aptly, while also employing appropriate corporate governance. Corporate governance relates to the framework of values under which an enterprise performs, and calls for transparency and accountability. Specifically, it refers to the procedures and rules, explicit and implicit, that provide the incentive framework for companies to attract financial and human capital, perform efficiently and avoid corruption.

The standard of corporate governance assumes importance from a macroeconomic and corporate standpoint. India's corporate governance system is a hybrid of the arm's-length market-based systems (followed in the UK and the US) and the insider-dominated bank-based systems (adopted in Germany and France).

Initially considered as a concept that addressed issues of the separation of ownership and control, corporate governance has subsequently evolved into a framework that deals with essential issues such as the enforcement of property rights, the protection of minority shareholders rights, self-dealing in the privatization process, the enforcement of contracts and so on.

Globalization trends

Globalization has led to a rapid movement of fundamental economic elements across borders: capital (both physical and financial), technology and labour.

To attract foreign investments, two forms of competition exist between nations: rules-based competition (regulatory in nature) and incentives-based competition (fiscal or grant-based). India inherited the rules-based governance system from the UK which, in addition to enforcing changes to regulatory norms, involves the process of market deregulation, privatization, and the liberalization of trade and investment policies. The new industrial policy of 1991 initiated a gradual process of economic reform deregulation, promotion of the private sector and trade liberalization. To regulate and monitor stock trading, the Securities and Exchange Board of India (SEBI) was established in 1992, laying the basic ground rules of corporate conduct in India.

In 1995-96, when the Finance Ministry and Indian financial institutions had informally decided to push for best practices, Sir Adrian Cadbury, who was instrumental in finalizing a corporate governance code in the UK, was invited to India.

The Confederation of Indian Industry's code for desirable corporate governance laid down by the Rahul Bajaj committee was comprehensively outlined in the Kumar Mangalam Birla committee report of SEBI, through the enactment of Clause 49 of the listing agreement.

It was applied to companies in the Bombay Stock Exchange 200, S&P C&X Nifty indices and all newly listed companies at the time. It was later extended to all listed companies with a paid up capital of over Rs30 million (US$700,000) from 31 March 2003. Rules applying to listed companies were refined even further by the Narayan Murthy committee.

As Indian corporations are gradually globalizing their funding, a transformation is taking place in corporate governance to meet the requirements of international capital markets. Immediate changes such as a greater transparency in accounts, the appointment of professional managers, greater sensitivity to shareholders' interest and a closer attention to profits, have become visible.

Foreign institutional investors are acquiring a significant stake in the Indian financial system, which is being improved to provide shareholders with a greater level of accountability.

Regulators realize that economic resources will only flow to corporations with impeccable corporate governance qualifications as it remains the key factor for assessment by global investors. For emerging economies like India, which are assimilating with the global economy, implementing important corporate governance reforms assumes vital significance.

The Indian corporate sector is marked by a relatively unsophisticated equity market, vulnerable to manipulation with rudimentary analyst activity, a dominance of family firms, and a generally high level of corruption.

Widespread corporate governance abuses by dominant shareholders against the interest of inactive minority shareholders illustrate the micro-management of routine business. For minority-investor protection, SEBI introduced pricing norms for the preferential allotment of shares and the mandatory condition which requires promoters to take a minimum of 20% of the equity stake in the capital of the company, retaining it for a lock-in period of three years. Such measures inspire confidence in investors.

Financial development is largely dependent on investor protection in India. Enhanced capital competence standards and prudential regulation have reduced risk aspects, placing India in a position to attract more foreign investment. With regulators and industry organizations pushing for improved corporate governance, and encouraging transparency in the system, shareholders can expect their investments to be closely monitored and remain secure.

Priti Suri is the proprietor of PSA. Neeraj Dubey is an associate at the firm.