ESG Viewpoint

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Corporate Governance in India

Goal: An overview of the local governance framework and our trip to India with the ACGA

Summary

- We travelled to India to take part in the Asian Corporate Governance Association (ACGA) annual conference. We gained valuable insights into local market nuances, and had the opportunity to express our views on the current state of governance in the region.
- Against a backdrop of some very public governance scandals, regulators continue to employ a rules-based approach to implementing good governance, but this has not proved effective.
- The Securities and Exchange Board of India (SEBI) determined that the recommendations to improve corporate governance practices by a specially constituted committee should be brought in to law, but discussions are ongoing about the approach which should be taken.
- As India continues its path towards better governance, international investors will play a key role in driving change.
- The emergence of an Indian Stewardship Code for local investors is welcome, but regulators should be mindful of relying too heavily on international codes that do not take in to account the Indian context.

Background

In the past ten years, India has faced public governance scandals at some of its largest blue chips. Examples include the Satyam accounting errors of 2009 (which in 2018 resulted in PWC being barred from conducting audits in India for 2 years), the disregard for minority shareholders' interests we saw at Tata Group in 2016, and the shareholder revolt over related-party transactions at Raymond in 2017. History has shown that each of these scandals has led to attempts at governance reform. However, repeated efforts from authorities to enact more laws have failed to have the desired impacts. Yet still, in October 2017, a specially constituted committee, named after its Chair, Mr Kotak, published over 80 recommendations on how to improve corporate governance standards at Indian companies. In March 2018, SEBI made its determination that most of the recommendations should be transferred in to the listing rules, but should we expect progression?

We consider many of the changes to be a step forward, but recognise that obstacles arising from local context may hinder the intended progress. Most Indian companies are run by their "promoters", a group of individuals or a family who set up and have effective control of the company. Promoter-run companies account for 45% of the market.

SEBI's governance changes to listing rules

Better board structure and effectiveness for top 1000 listed entities

- Reduction in the maximum number of listed entity directorships from 10 to 8
- Expanding the eligibility criteria for independent directors
- Enhanced role of the Audit Committee, Nomination and Remuneration Committee and Risk Management Committee.
- Disclosure of expertise/skills of directors
- Separation of CEO and Chair, initially for the top 500
- Quorum for Board meetings
- At least one female independent director at the top 500 listed entities

Improved oversight for all investors

- Top 100 entities to hold AGMs within 5 months after the end of FY 2018-19
- Webcast of AGMs will be compulsory for top 100 entities by market capitalisation
- Shareholder approval (majority of minority) for royalties to related parties exceeding 2% of consolidated turnover
- Disclosures of auditor credentials, audit fee, reasons for resignation of auditors, etc.
- Enhanced disclosure of related-party transactions
- Mandatory disclosure of consolidated quarterly results with effect from FY 2019-20

India Trip

In November 2017, we travelled to India for the Asian Corporate Governance Association annual conference. Our engagement with regulators and companies allowed us to gain valuable insights into market developments aimed at improving governance standards at Indian companies. We welcomed the growing interest of market participants in issues around market discipline for promoters, protection of minority shareholder rights, and the development of a uniform Investor Stewardship Code.

Key takeaways

India does not need more regulation; better enforcement is required.

India has traditionally relied on regulation to promote its corporate governance agenda. However, the ubiquity of the promoter-led model in which it is widely accepted that promoters' self-interests precede the interests of minority shareholders, has made effective enforcement of corporate governance norms particularly challenging.

In Q1 2018, SEBI proposed creating a new set of rules aimed at improving corporate governance standards. These rules stem directly from the 80 recommendations put forward by the Kotak Committee on Corporate Governance on a wide range of issues from improved board structure and effectiveness to enhanced disclosure of related-party transactions. SEBI also announced revisions to the enforcement framework, including procedures to suspend trading a company's stock in the event of persistent non-compliance with governance rules.

We view these changes as a step forward but recognise that obstacles arising from local nuances may hinder progress. Not only do promoters have large economic stakes and the voting rights to match, but under Indian law they also bear additional financial liability for the company. This serves to proliferate a reluctance to depart from the 'by-the-book' application of stringent regulation in the market as a whole. In our view, however, a rules-based approach alone will not be sufficient to improve company accountability to minority investors. The greatest impact would come from a cultural shift and understanding of the merits of best governance practice by promoters.

Enforcement action
Fines Levied

Regulation wise fines levied total (cumulative)

Regulations	No. of companies	Total fine levied (Rs. in million)
Corporate Governance	103	40.5
Shareholding Pattern	143	118.5
Financial Results	242	475.5
Annual Report	213	37.5

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Action against company and promoters (cumulative)

Activity	2017-18 (until 31 Oct 2017)	2016-17	2015-16
No. of companies securities transferred to BZ (trade or trade)	8	24	25
No. of companies promotor holding frozen	13	24	23
No. of companies suspended	9	21	23

Is a "comply or explain" approach practical in India?

The "comply or explain" approach, which is at the core of Corporate Governance Codes in many developed and emerging markets, is not well understood by many market participants in India. Commentators have noted that both regulators and promoters in India operate under a cloud of perceived corruption. The result is that they feel better protected by existing tick-box approaches to compliance with specific corporate governance rules and are less inclined to move to a model that would see emphasis placed on interpretation of governance best practice. Analysts in the market believe that the success of any approach based around "comply or explain" principles would be heavily dependent on a push for better stewardship from an engaged local investor base, which India does not have at present.

Is a Stewardship Code the answer?

2017 brought about an interesting development when the Insurance Regulatory Authority of India (IRDA) published its own Stewardship Code, setting forth principles that should be adopted by insurers in their capacity as some of India's largest institutional investors. We welcomed this move, yet recognise that, in the future, the market will need one uniform code for all investor participants. Such a code should also provide guidance on how foreign institutional investors (FII) interact with companies, given the specific context that guides corporate India. This includes the central role promoters[2] play and the influence of state-owned companies have on market practices.

> These higher standards might lead to increased foreign investment, with investors willing to pay a premium for reduction in corporate governance risk.

The need for independent audit regulation

Some of the key takeaways from ACGA discussions around independent audit committees included:

- An independent audit regulator is likely to improve overall audit quality. However, to have real impact, there should be a broad regulatory remit, similar to the UK's Financial Reporting Council.
- Communication between the auditor and the company is important. There should be disclosure of key audit matters in the auditor's report.
- Investors should focus more on audit committee effectiveness rather than solely its independence.

One of the main concerns we see in the Indian market is a lack of accountability by audit committees. As investors, we believe that we are better protected by corporate structures which ensure that audit committees are able to assess and challenge management assumptions. To this end, we see the competence and independence of audit committee members as a key requirement for effectiveness.

Effecting change

Are there other ways to promote corporate governance best practice in the Indian market? One could look at developments in Brazil, specifically its Novo Mercado segment. B3, the Sao Paulo Stock Exchange, created a premium listing segment where the fulfilment of certain corporate governance best practices is a pre-requisite. These higher standards might lead to increased foreign investment, with investors willing to pay a premium for reduction in corporate governance risk. This approach could work well in India where emphasis is placed on local perception. Furthermore, India is less dominated by a handful of large corporations, which could compromise the effectiveness of a "premium segment" approach as we have seen happen in the Philippines.

Conclusion

Great challenges still exist in relation to the implementation of good governance provisions. Fundamentally, we believe that there will need to be a cultural shift for company promoters to understand the benefits that an engaged shareholder base can bring.

We are encouraged by the direction of travel overall, which includes talks on the implementation of an Indian Stewardship Code. Its chances of success hinge on companies recognising the need to migrate to more robust governance structures and, crucially, on local and international investors playing a more active stewardship role.

[2] Most Indian companies are run by their "promoters", a group of people or a family who set up and have effective control of the company. Indian corporate structures are typified in this way, promoter run companies account for 45% of the market, with foreign and governmental ownership representing a further 25% respectively

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