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Contents

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IPBA News

4 The President's Message

6 The Secretary-General's Message

7 Message to Readers from the Chair of the Publications Committee

8 IPBA Upcoming Events

Legal Update

9 The European Union Project on Sustainable Governance
by Sara Marchetta, Italy

14 Ethics and Corporate Governance in the Digital Age and Challenges for Enterprises
by Bui Cong Thanh (James Bui), Vietnam

20 Transformation of Humble Humanisation into a Good Corporate Citizen
by Dej-Udom Krairit and Kanitta Petchsoongsakul, Thailand

26 Corporate Governance in the United Arab Emirates: The New Challenges
by Mohammed Alsuwaidi, UAE

32 Corporate Governance and Ethics: A New Challenge to Corporate Governance
by Monchai Varatthan, Thailand

37 Challenges in Corporate Governance in India Post-Pandemic
by Srishti Singhania, India

Member News

43 IPBA New Members June 2021 to August 2021

Challenges in Corporate Governance in India Post-Pandemic

Introduction

The COVID-19 Pandemic has thrown up a number of challenges in the functioning of businesses and impacted the working of companies across the globe. This in turn has affected corporate governance of companies worldwide.[1] The Pandemic has also brought into the picture some new challenges with respect to corporate governance like the initiation of virtual meetings, remote governance of the corporate ecosystem, and has increased the importance of corporate social responsibility. Resolving corporate governance challenges has become extremely important for both supporting the recovery of companies from the COVID-19 crisis as well as strengthening their resilience to possible future shocks.[2] Corporate governance is the tool for effective operation of the company, mitigation of risk, compliance with the law, enhancing shareholder value and maintenance of the image of the company during such economic downturn.[3] Thus, this article seeks to discuss various challenges faced by India's corporate governance landscape, the need to combat them post-Pandemic and how to effectively counter these diverse challenges by looking at the legal framework of other countries.

This article seeks to provide an overview of issues with respect to separation of ownership and management, board composition, compliance with corporate social responsibility ('CSR') policies and the risk of fraud. Further, these corporate governance issues are not peculiar to India but are replicated across countries. Thus, it will be interesting for other countries to learn from these challenges and take back plausible solutions.

Separation of Ownership and Management

Challenges

The main challenge for companies is centred around optimisation of functioning and leadership to effectively accommodate the interests of all stakeholders. This issue of separation of management and ownership has been ever-present but has become even more important since the Pandemic. It has become difficult to remotely monitor the influence of the owner-shareholders on management decisions and to ensure these decisions result in balanced outcomes during these unprecedented times. This issue is particularly faced with respect to family-owned companies and Indian companies having concentrated shareholding patterns, which is discussed further below.

Family-owned Companies

In a study conducted by the National Stock Exchange regarding family-owned companies, it has been observed that it is largely the extent of control exercised by the family that determines performance and profitability of the firm.[4] Although these businesses are facing negative impacts of the Pandemic, their concerns

largely revolve around short-term revenue rather than long-term survival as compared to other companies with dispersed ownership structures. Interestingly, it has been observed in the USA that family businesses are experiencing the Pandemic in a manner different from other businesses[5] due to the intricate relationship between the family members. Thus, it becomes even more important for family-owned companies to separate their ownership from management for effective functioning of these companies and to be able to combat the crisis. One plausible way in which separation of ownership and management can be achieved is by the family members holding non-executive positions on the board and entrusting the management to professionally qualified managers.[6]

Concentrated Shareholding

A concentrated shareholding pattern has been one of the primary features of Indian companies for a very long time.[7] As a result of the majority shares being held by promoters, the agency problems are reinforced and there often exists conflicting interests between the shareholders and management. In the situation of the Pandemic, these were characterised by, *inter alia*, the dilemma reflected in the equity of returning cash to shareholders when the employees were being increasingly laid off or when deciding on whether to suspend or reduce dividends.[8] Dividend cuts have been adopted across the world as a measure[9] to meet the challenges thrown up due to the Pandemic. However, such a step may be detrimental to the interest of shareholders and could be potentially ignored where the separation of ownership and management is absent in totality or is extremely limited.

Position of Minority Shareholders

The Pandemic has created communication problems due to the virtual shift in operations often causing unavailability, personal issues, network issues and so on. In such a virtual scenario, minority shareholders may not be able to effectively counter oppression by the majority. The precarious position of minority shareholders with majority shareholders acting as shadow directors is further evidenced by the controversial Tata-Mistry case.[10] In the said case[11], holding in favour of Tata Sons, the Supreme Court of India clarified that minority shareholders were not automatically entitled to a seat on a private company's board, absent any statutory provision to that effect. This decision has ramifications for minority shareholders at large who may now have to agree with the majority shareholders and promoters to get such rights (a board seat) expressly incorporated in the Articles of Association of the company.[12] Considering this, negotiating with the promoters during the Pandemic would be even more problematic because of the communication and coordination problems highlighted above.

Addressing the Problems

In order to address the challenges posed due to the ownership structure of most Indian companies—either largely family-owned or characterised by excessive promoter control—provisions mandating separation of management and ownership in all companies is the need of the hour. If the management is separated from ownership, shareholders would be better placed to hold the directors of the company liable for decisions. It is also more likely that the interest of all stakeholders would be taken into account, ensuring effective human capital management ('HCM'). In this regard, the Pandemic has heightened the demand for disclosure of HCM data like employee turnover, safety incidents, gender pay gap and so on, as disclosed in USA and Canada.[13] Such disclosures could help the shareholders in holding the management responsible and accountable.

Board Composition

Challenges & Plausible Solutions

Like the previous issue, challenges relating to the composition of the board in terms of gender diversity, types of directors (independent, non-executive, nominee) have also been largely present in the Indian corporate governance context. The increased focus on diversity, equity and inclusion ('DE&I') in corporate boards across the globe, makes it even more important for Indian companies to pay heed to such issues to be at par with multi-national companies. However, the Pandemic has posed some unique challenges when it comes to ensuring gender diversity among boards of directors.

Gender Diversity

In a bid to ensure gender diversity, Proviso 2 of Section 149(1)(b) of the Companies Act 2013 ('the Act') read with Rule 3 of the Companies (Appointment and Qualification of Directors) Rules 2014 makes it mandatory for '(a) every listed company and (b) every other public company having paid–up share capital of one hundred crore rupees or more; or turnover of three hundred crore rupees or more to have at least one woman director on its board of directors'.[14] Further, the

Securities and Exchange Board of India ('SEBI'), vide clause 49 of Listing Agreement relating to Corporate Governance, made having one woman director compulsory from October 2014 onwards.[15] International commitments and the equality provisions in the Constitution of India also justify appointment of women on corporate boards. Despite such provisions, the lack of adequate female representation on corporate boards is a glaring issue. This is further amplified because of the large number of family-owned companies in India which tend to circumvent the female director mandate by appointing someone from the family on the board.

In order to have meaningful representation on the board, it is essential to begin at the grass-roots level since it is these women, appointed at the lower levels, who go on to become members of the board. However, the Pandemic, having put in place a 'work from home' system, has made it even more challenging for women to balance work and home, as a result of which women are exiting the workforce.[16] This in turn is affecting the presence of women at higher positions like on corporate boards. In the USA, for instance, up to two million women (mothers in particular) are considering leaving the workforce or downshifting their careers.[17] To address this issue, in addition to having a mandate of appointing women at the highest echelons, there have to be codified requirements of providing a flexible work environment to women and in fact employing women in the first place. This is especially true in the case of public sector companies that tend to have very little female intake at the entry level itself.[18]

A concentrated shareholding pattern has been one of the primary features of Indian companies for a very long time.

Gender diversity has received attention from countries across the globe, including the USA and Canada, Brazil, the UK, Australia, Japan and Singapore.[19] The steps taken by these countries can serve as potential takeaways for India. In Brazil, the Institutional Shareholders Services, a proxy voting advisory institution, has included gender diversity and onboarding in its board election policy guidelines. Starting 2022, these guidelines seek to recommend negative votes in the absence of a female director on the board.[20] Some of these countries, like the UK, Japan and Singapore, have pre-determined targets of having a certain percentage of the total board composition as women.[21] This is something that should be strictly enforced in India as well.

Independent Directors

The concept of independent directors was brought in by the Kumar Mangalam Committee in 1999 and was hailed as the biggest corporate governance reform.[22] However, the reality has been very different from what was envisaged since promoters and majority shareholders exercise significant control over the appointment and functioning of such directors. The true independence of independent directors has been an area of concern, especially in public sector undertakings ('PSUs'). In an investigation conducted by the Indian Express newspaper under the Right to Information Act, it was found that a large number of independent directors in PSUs had links and affiliations with the ruling party.[23] Further, even in the private sector, retired government officials are preferred to be appointed as independent directors and, in some instances, are appointed even before the mandatory post-retirement cooling period expires.[24]

Another instance of the lack of independence of supposedly independent directors is reflected by the ability of promoters or majority shareholders to easily remove independent directors. The ousting of Nusli Wadia as an independent director in the aforementioned Tata-Mistry case serves testimony to this aspect. Wadia was fired since he stood in favour of Cyrus Mistry (an erstwhile director of Tata Sons) in terms of maintaining chairmanship in the Tata group of companies.[25] This clearly reflects a situation of abuse of power of the promoters and majority shareholders and raises serious doubts about the efficacy of the independent director position itself. In order to strengthen the position of independent directors, SEBI has recently tightened rules (to be effective from 1 January 2022) for both appointment/re-appointment and removal of such directors.[26]

As per these new provisions issued by SEBI, a special resolution is now required for appointment or removal of independent directors, such approval being required at the next annual general meeting or within three months of appointment at an extra-ordinary general meeting, whichever is earlier. In addition, two thirds of the total

members on the audit committee and the nomination and remuneration committee are to be independent directors.[27] Disclosure of a resignation letter and a year-long cooling off period for transition from independent director to executive director in a company has also been mandated.[28] A three-year cooling off period has also been put in place for appointment of employees of promoter group companies and key managerial personnel as independent directors.[29] These changes are aimed at increasing the role of public shareholders, addressing the issues raised on the efficacy of independent directors and ensuring better corporate governance overall.

Independence of boards is an issue that is most prominently manifested in India, although companies in the EU, Japan and Singapore also face this issue; these countries are constantly realising the importance of independent directors and have also seen a rise in number of such appointments vis-à-vis other directors.[30] In Singapore, for instance, starting 2022, Singapore Exchange listing rules will require corporate boards to have at least one third independent directors and directors having served more than nine years on the same board will be subject to a two-tier vote by shareholders on their independence.[31] Japan on the other hand reflects an indirect way out: related-party transactions have been subject to increased scrutiny leading to investors focusing on the importance of appointment of independent directors.[32] Indian regulators could adopt such measures as well.

Corporate fraud and scams represent some of the biggest failures of corporate governance in India and is a continuing issue to this day.

Corporate Social Responsibility Compliance

Environmental, social and governance ('ESG') management has emerged as an important consideration globally, warranting compliance with government-mandated standards for the same. This has been amplified by the Pandemic, as the role of companies in ensuring social and economic equity as part of good business practices, has been emphasised and the relation between business and society has been brought to the forefront. The global prediction for 2020 has seen a greater emphasis on the 'E' and 'S' with the growing awareness of climate change, and the Pandemic having forced companies to reassure stakeholders about their commitment to the health and safety of their workers.[33] In India, CSR is one area that has seen significant development during the Pandemic.

The newly introduced Companies (Corporate Social Responsibility Policy) Amendment Rules 2021 ('New CSR Rules') and the amendments made to Section 135 of the Companies Act 2013 overhaul the CSR framework in India. Owing to the COVID-19 Pandemic, the Ministry of Corporate Affairs ('MCA') permitted consideration of the expenditure of companies to fight the Pandemic (like engaging in healthcare, sanitisation, disaster management and so on) as valid under CSR activities.[34] The MCA has also issued multiple clarifications on what could be considered as CSR expenditure to assist companies in compliance and finalising CSR budgets, especially in light of the second wave of the pandemic in India. As per the New CSR Rules, a greater role of the CSR Committee and the board is envisaged. While the CSR Committee is mandated to formulate an annual action plan for CSR spending, the board steps in for passing resolutions to approve CSR projects and setting off excess CSR funds. In addition, under the New CSR Rules, companies are now permitted to take the assistance of international organisations for designing, evaluating and monitoring their CSR activities.

The New CSR Rules increase governance and transparency of CSR projects owing to the mandate of disclosing the composition of the CSR Committee, the CSR policy of the company and details of the projects undertaken. Since there is a mandatory requirement of impact assessment of CSR projects, governance of the projects at the ground level as well as assisting the independent agency undertaking such impact assessment is required. In addition, the annual disclosures also have to be more detailed requiring monitoring. The excess unspent CSR funds have to be transferred to an 'Unspent CSR Account' and, if not utilised for three years, have to be transferred to any fund specified in Schedule VII of the Companies Act 2013.[35]

These provisions warrant close attention in terms of corporate governance because of the mandatory nature of the obligation and a shift from 'comply or explain' to 'comply or pay penalty'. In case of non-compliance, the defaulting company is liable to payment of monetary

penalty to the tune of Rs. 1 crore (approximately US$135,000) or twice the amount that should have been transferred to the unspent CSR account, whichever is lesser. The defaulting officer is also liable pay the lesser of Rs. 2 lakh (approximately US$2,700) or one tenth of the amount that should have been transferred to the unspent CSR account.[36] From a corporate governance perspective, the New CSR Rules can be seen as an attempt at effective ESG Management, an aspect that has gained substantial attention across the globe during the Pandemic years in particular. India's CSR policies reflect best practices and can serve as an example for other countries in this regard.

Risk of Fraud

Corporate fraud and scams represent some of the biggest failures of corporate governance in India and is a continuing issue to this day,[37] ranging from the recent ICICI Bank bribery case[38] to the Satyam scam[39] more than a decade ago. In fact, the increased attention to corporate governance was brought after such scams started coming to light. The large amounts of funds involved in these scams make it an extremely grave issue, especially since it is often the hard-earned money of the general public that is at stake. Experts have identified an increase in fraud and corporate misconduct due to Pandemic-induced financial stress as a grave concern, with the 2008 financial crisis serving testimony to the impact of such major disruptive events.[40] The pressure created due to a bad economy, coupled with less oversight due to remote governance, provides fertile ground for operation of fraudsters.[41]

More specific to the challenges thrown up due to the Pandemic, there is a looming fear of revival and recovery being derailed by risks of corruption, bribery and fraud.[42] Employees working from home have been given access to accounting and financial systems from less secure places, such as their homes, making supervisory oversight in a remote manner very difficult and challenging. Also, cybersecurity measures have gained importance owing to the virtual shift in operations. It was found that 38 per cent of organisations in the USA have increased their budget for anti-fraud technology in 2021 and more than 80 per cent have, in response to COVID-19, already made changes to their anti-fraud programs.[43] These are some measures that could be adopted by Indian companies as well.

Further, there has been a heightened demand for transparency in operations, in the interest of privacy and data protection. Corporate communication and disclosures have significantly changed during the Pandemic. This is not just unique to India, but is instead a global issue. Internal controls are the need of the hour; a strong whistleblower policy protecting bona fide whistleblowers could help check employee-driven fraud and should be considered as an effective pillar of corporate governance.[44] Companies need to be proactive and take steps to first, assess where their vulnerabilities to be a victim to fraud lie; second, institute fraud mitigation procedures (like strengthening the whistleblower policy); and, third, actively monitor red flags.[45]

Conclusion

The Pandemic has highlighted the importance of corporate governance and posed new challenges in jurisdictions across the world. Having robust corporate governance mechanisms, adopting risk management strategies and identifying the purpose of undertaking business itself have become crucial to combat this crisis. However, corporate governance is not a short-term goal to combat this crisis, but is in fact a long-term goal for the growth of companies. Separation of the management and ownership and ensuring true independence of directors ensures effective management of the company and in turn helps in increasing the valuation of the company. Corporate Social Responsibility helps in contributing to society and building the goodwill of the company. India is on the path of adopting the best corporate governance norms from across the world, however, there is room for ensuring effective implementation. The challenges faced by India with respect to corporate governance are common to many other countries. Thus, there is a need to discuss these challenges together and come up with harmonious solutions for the prosperity of the world economy.

Notes

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