

Recent Trends Of Corporate Governance And Relevant Regulations Of Capital Markets In India

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INTRODUCTION

Corporate governance is about maximizing shareholder value legally, ethically and on a sustainable basis, while ensuring fairness to every stakeholder - the Company's customers, employees, investors, vendor-partners, the government of the land and the community. Thus, corporate governance is a reflection of a company's culture, policies, and its relationship with the stakeholders, and its commitment to values. Corporate governance had its origins in the 19th century, arising in response to the separation of ownership and control following the formation of joint stock companies. The owners or shareholders of these companies, who were not involved in day-to-day operational issues, required assurances that those in control of the Company, the directors and the managers, were safeguarding their investments and accurately reporting the financial outcome of their business activities. Thus, shareholders were the original focus of corporate governance.

An effective supervisory or regulatory system set up for achieving its objectives must have clear responsibilities and authority. Though there have been theories to explain the forms of regulations, more or less, the basic objective of regulations has remained the same- maintain financial stability, protect investors and reduce financial crime by disciplining the financial markets. Providing financial stability is very important as the costs of financial distress are very high and this has been proven time and again.

The social costs to investors during the period of great depression and when the stock market crashed in 1929, 1970s, 1996 and during the tech bubble burst in 2001 were very high and this also affected the financial markets of many countries. India too experienced them when markets crashed in April 1992, in the year 2000, in May 2004 and in August 2007. In pursuit of providing financial stability, protecting the investors and disciplining the markets by fostering competition, nations have set up regulatory structures to regulate the financial markets for better financial and economic stability.

OBJECTIVES AND METHODOLOGY OF THE STUDY

The objectives of the study are:

- 1) To study the corporate governance system and initiatives to promote corporate governance in the Indian capital market;
- 2) To study the regulatory mechanism, regulatory measures and policy initiatives in the Indian capital market.

The main source of data is secondary data. Secondary data has been collected from the internet, published reports and from the fact sheets of SEBI, RBI and other organizations. For analysis of the data, simple percentage had been used.

CORPORATE GOVERNANCE SYSTEM IN INDIA

The emergence of corporate governance is due to the prospective conflicts of interest among participants involved in the entire process, i.e., stakeholders in the corporate structure. This conflict of interest is commonly termed as the agency problem. It arises due to two important reasons - namely different goals and preferences between different participants and imperfect information about each other's actions, knowledge and preferences. Certain factors like the composition of the board of directors, laws and regulations, financing agreements, labor contacts, market for corporate control, etc., are primarily responsible for the constitution and influences for corporate governance. However, above all, the emergence of institutional investors as equity owners affects the corporate governance issue to a larger extent. Institutional investors influence the management activities by their ownership and share trading. The institutional investors, especially foreign institutional investors play an important role in endorsing the system of

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corporate governance.

In India, the corporate governance system is a hybrid of the outsider dominated market-based system of the UK and the US, and the insider dominated bank system of Germany and Japan. In developing countries, corporate governance ownership is found to be heavily concentrated. The developing countries profoundly rely on bank and equity markets to finance long-term projects in contrast to the developed countries. After the adoption of structural adjustment programs and globalization in 1991, the corporate governance of companies plays a very important role. Companies are opened up to the external source of finances from the debt and capital market. This calls for a greater need for investor protection. In India, most activities rely on the external sources of finance, and insider dominated family business. If we study the BSE, of the 30 listed companies, around 6 were family-owned listed companies as on 30th June 2006. The principal holders of corporate equities are **1) Private Holding, 2) Foreign Institutional Investors and 3) Banks, FIs and insurance companies.**

There is a higher concentration of shareholding patterns of companies, which is a dominant feature of family-owned businesses. In 12 companies out of the BSE listed 30 companies, the share of foreign institutional investors was more than 20%. In India, the existence of insider control and ownership system, coupled with relatively weak external disciplining mechanism like less developed capital and take over market makes the case of shareholders' activism all the more important. It can deteriorate expropriation incentives by insiders, but the success depends on maintaining a relatively continuous and stable management structure. It can be supported by the insider ownership with interlocking directorates, cross holdings and family control. A study done by independent stockbroker - Asia Pacific Market and the Asian Corporate Governance Association (ACGA) ranked India at the 3rd position.

The key variables for assessing the corporate standards are rules and regulations, enforcement, the political and regulatory environment, the adoption of international accounting standards, the institutional landscape and corporate governance culture. The shareholders' activism is largely an undersized force in India. The shareholders have greater authority in the management that depends on the factors such as investor education, better organization of investor groups, and association with professional bodies, and business organizations.

Conflict of interest between shareholders, board of directors and senior managers like CEOs is not new in the corporate world. The outcome of conflict management depends upon the effectiveness of changes in governance approach, board representation and architecture. Of late, due to the radical increase in the institutional shareholders, the issue of shareholders rights occupied a crucial place across the globe. In the US, the shareholders provide more emphasis on voting rights, where as in the UK, the focus is on board composition and structure, management compensation and disclosure of information that is at the center stage. The Indian shareholders have potential voting rights, and can even resort to voting through proxies. They have the right to remove a director before the expiry of his tenure by ordinary resolutions. A survey conducted by Brown Jr. (1998) on 240 institutional investors and fund managers revealed that corporate governance acts as a means to an end in protecting or improving financial performance. Empirically, the study found that there was a widespread shareholder activism among the majority of the firms. More than 80% of the fund managers told that their organization had voted for a shareholder's resolution.

THE INITIATIVES TO PROMOTE CORPORATE GOVERNANCE

✿ **Worldwide Scenario:** The Treadway Commission was formed in the U.S. in 1985 following a number of financial failures, frauds and questionable business practices reporting in 1987. The commission found that breakdowns in internal control were a contributing factor in nearly 50% of fraudulent financial reporting. In 1987, the Committee of Sponsoring Organizations' (COSO) of the Treadway Commission defined three objectives for internal control in their final framework, which was issued in 1992: viz., Effectiveness and efficiency of operations, Reliability of financial reporting and Compliance with laws and regulations. Safeguarding of assets was added as an objective in 1994.

The Cadbury (internal financial control) and Greenbury (disclosure of directors' remuneration) Committees report published in the United Kingdom is a landmark. As the debate on corporate governance was still raging, the Hampel Committee was formed towards the end of 1995. This committee issued its report in 1998, and highlighted the role of corporate governance as a contributor to business prosperity, in addition to its previous focus on financial reporting.

The Hampel report incorporated the recommendations from both the Cadbury and Greenbury committees and was published as the Combined Code in June 1998. In addition to reviewing the effectiveness of internal financial controls, the Hampel report recommended that the directors review all internal controls. The Turnbull Committee was

subsequently established to provide guidance on this issue.

The Higgs Report on non-executive directors, and the Smith Report on audit committees, both published in January 2003, form a part of the systematic review of corporate governance being undertaken in the U.K. and Europe. The recommendations of these two reports are aimed at strengthening the existing framework for corporate governance in the U.K., enhancing the effectiveness of non-executive directors, and switching the key audit relationship from executive directors to an independent audit committee.

Following the corporate governance scandals in the U.S., the Sarbanes-Oxley Act was enacted, which brought about fundamental changes in virtually every area of corporate governance and particularly in auditor independence, conflict of interest, corporate responsibility and enhanced financial disclosures.

❖ **Indian Scenario:** In India, the industry, rather than the government, provided the initial impetus for corporate governance reforms. Driven by a desire to make Indian businesses more competitive and respected globally, the Confederation of Indian Industries (CII) published a voluntary Code of Corporate Governance in 1998, one of the first major codes in Asia. The Securities and Exchange Board of India (SEBI) appointed the Committee on Corporate Governance on May 7, 1999, under the chairmanship of Mr. Kumar Mangalam Birla, member of SEBI Board, to promote and raise the standards of corporate governance. The SEBI Board considered and adopted the recommendations of the committee in its meeting held on January 25, 2000. In accordance with the guidelines provided by SEBI, the market regulator, the stock exchanges had modified the listing requirements by incorporating in the listing agreement, a new Clause 49, so that proper disclosure for corporate governance is made by companies in the following areas: Board of Directors, Audit Committee, Remuneration Committee, Board Procedure, Management Discussion and Analysis, Information to Shareholders, and Report on Corporate Governance in the annual report.

SEBI instituted and incorporated another committee under the chairmanship of Mr. N. R. Narayana Murthy and the committee's recommendations to enhancements in corporate governance were duly accepted. The revised Clause 49 of the committee came into effect from January 1, 2006. The terms of reference to the committee were to review the performance of corporate governance, and to determine the role of companies in responding to rumors and other price-sensitive information circulating in the market, in order to enhance the transparency and integrity of the market. The committee came out with two sets of recommendations: the mandatory recommendations and the non-mandatory recommendations.

The mandatory recommendations focused 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, requiring corporate executive boards to assess and disclose business risks in the annual reports of companies, calling upon the Board to adopt a formal code of conduct, the position of nominee directors, and improved disclosures relating to compensation to non-executive directors and shareholders' approval of the same.

The non-mandatory recommendations pertain to moving to a regime providing for unqualified corporate financial statements, training of Board members and evaluation of non-executive directors' performance by a peer group comprising of the entire Board of Directors, excluding the Director being evaluated.

THE REGULATORS OF CAPITAL MARKETS IN INDIA

❖ **Introduction to Capital Markets:** The Indian capital market is broadly divided into the gilt-edged market and the industrial securities market. The industrial securities market is further divided into primary market and secondary market. *The Primary market (new issue market)* deals with the 'new securities'. The new offerings by the companies are made either as an initial public offering (IPO) or rights issue. *Secondary market/ stock market (old issues market or stock exchange)* is the market for buying and selling of securities of the existing companies. The stock exchanges are the exclusive centers for trading of securities.

The resource mobilization through *Public and Right Issue* and the trends in resource mobilization during the last 2 years has been given in the Table 1. During 2009-10, 76 issues accessed the primary market and raised ₹ 57555 crore through public (47) and rights issue (29), as against 47 issues, which raised ₹ 16220 crore in 2008-09 through public (22) and rights issues (25). Due to a better financial environment, there were 39 IPOs during 2009-10, as against the 21 during 2008-09. The amount raised through IPOs during 2009-10 was significantly higher at ₹ 24696 crore as compared to ₹ 2083 crore during 2008-09. The share of public issues in the total resource mobilization increased to

85.6 percent during 2009-10 from 22.1 percent in 2008-09, whereas, the share of rights issues declined from 77.9 percent in 2008-09, to 14.5 percent in 2009-10. It is observed from the Table 2 that the gross mobilization of resources by all mutual funds during 2009-10 was ₹ 10019022 crore compared to ₹ 5426353 crore during the previous year, indicating an increase of 84.7 percent over the previous year. All mutual funds put together recorded a net inflow of ₹ 83080 crore in 2009-10, as compared to an outflow of ₹ 28296 crore in 2008-09. The assets under management by all mutual funds increased by 47.2 percent to ₹ 613978 crore at the end of March 2010, from ₹ 417300 crore at the end of March 2009.

Particulars	2008-2009		2009-2010		% Share in total amount	
	No.	Amount	No.	Amount	2008-2009	2009-2010
1. Public Issues (i)+(ii)	22	3583	47	49236	22.09	85.55
(i) Public Issues	21	2083	44	46736	22.09	85.55
IPOs	21	2083	39	24696	12.84	42.91
FPOs	0	0	5	20041	0.00	34.82
(ii) Public issues (Bonds/NCD)	1	1500	3	2500	9.25	4.34
2. Right Issue	25	12637	29	8319	77.91	14.45
3. Total (1+2)	47	16220	76	57555	100.00	100.00

(Source: SEBI & RBI)

Period	Gross mobilization	Redemption	Net inflow	Assets at the end of the period
2005-06	1098149	1045370	52779	231862
2006-07	1938493	1844508	93985	326292
2007-08	4464376	4310575	153802	505152
2008-09	5426353	5454650	-28296	417300
2009-10	10019022	9935942	83080	613978

(Source: SEBI & RBI)

Market capitalization in terms of GDP indicates the relative size of the capital market, besides investor confidence and discounted future earnings of the corporate sector. Table 3 exhibits that (as on January 12, 2007) the market capitalization (NSE) at US\$834 billion was 91.5 per cent of the GDP. India's market capitalization compares well with other emerging economies and shows signs of catching up with some of the mature economies.

Country	Market Capitalization (₹ in Crores)	Mkt. Capitalization as % of GDP
China	1,000	33.3
India (NSE)	834	91.5
Japan	4800	96.0
Malaysia	251	181.3
South Korea	754	94.1
Thailand	141	72.7
USA	17,400	133.8

Note: GDP for India relates to 'advance estimate' for 2006-07, while those for other countries relates to calendar year 2006. Source: Derived from various country sources

INTRODUCTION TO REGULATIONS

Regulation means the establishment of rules usually enacted and approved through legislation, and supervision is monitoring and enforcement of these rules by an administrative body established for that purpose. Moreover, basic functions of a financial system include the effective transferring of capital resources among the sectors, quick clearing and settlement of payments, pooling of resources for diversification, and managing the risk and maintaining confidence in the financial system and also, development of financial markets.

By regulating the financial markets, the system regulates both macro and micro factors of stability. The macro factors include controlling the flow of foreign exchange, regulating interest rates and the payment system. These are generally controlled and regulated by the central bank. The macro factors are controlled by supervising the clearing house and settlement systems in the country. The second objective of financial regulation is to bring in transparency in the market and protect the investor. Transparency involves dissemination of timely and correct information to the investors and also, the dissemination of information regarding takeovers and public offers. The third objective of financial regulation is promoting competition by preventing the formation of cartels and disciplining the markets from abuse by dominant positions and from restricting the market accessibility to a few selected individuals. The fourth objective is developing capital markets and making arrangements for availability of capital for investments in the markets.

The Indian financial sector is currently regulated by regulators, which include Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), Forward Market Commission (FMC), National Bank for Agricultural and Rural Development (NABARD), Insurance Regulatory and Development Authority (IRDA), National Housing Board (NHB), State Finance Corporation (SFC) and the Board for Financial Supervision (BFS).

✿ **The Policy Initiatives of Regulatory Authorities:** The Securities and Exchange Board of India (SEBI) is the regulatory authority established under the SEBI Act 1992, in order to protect the interests of the investors in securities as well as to promote the development of the capital market. It involves regulating the business in stock exchanges; supervising the working of stock brokers, share transfer agents, merchant bankers, underwriters, etc.; as well as prohibiting unfair trade practices in the securities' market.

✿ **Recent Regulations and Policy Measures:** A number of initiatives have been undertaken by the Government, from time to time, so as to provide financial and regulatory reforms in the primary and secondary market segments of the capital market. These measures broadly aim to sustain the confidence of investors (both domestic and foreign) in the country's capital market. The Recent Regulations in the capital markets have been taken by SEBI through new regulations and through amendments to the existing regulations.

NEW REGULATIONS

✿ **The Securities and Exchange Board of India (Investor Protection and Education Fund) Regulations, 2009:** This new regulation provides that the fund shall be utilized for the purpose of protection of investors and promotion of investor education and awareness.

✿ **The Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009:** This regulation lays down the procedure for voluntary as well as compulsory delisting of equity shares of a company.

✿ **The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009:** Some of the significant changes made through these regulations are: **a)** Exemption from eligibility norms for making an IPO available to banking companies, **b)** Offer for sale by listed companies has been provided for., **c)** Allotment/refund period in public issues has been fixed as 15 days. Disclosure of price or price band is not required to be disclosed in the draft prospectus. **d)** Transfer of surplus money in Green Shoe Option (GSO) Bank Account to the IPEF.

AMENDMENTS TO EXISTING RULES/ REGULATIONS

✿ **Amendment To The SEBI (Mutual Funds) Regulations, 1996:** This regulation was amended to **a)** Make listing of close ended schemes mandatory, **b)** Remove the provision available for repurchase and re-issue of units of close-ended schemes and to provide that the units shall not be repurchased before maturity. **c)** Provide for listing fees as a

permissible expenses as part of the recurring expenses chargeable to scheme. **d)** Close-ended debt schemes may be allowed to invest in securities of initial or residual maturities not exceeding the maturity of the scheme.

✿ **Amendment To The SEBI (Credit Rating Agencies) Regulations, 1999:** This regulation was amended to provide for the following: **a)** Where the credit rating agency proposes to change its status or constitution, it shall obtain prior approval of SEBI for continuing to act as such after the change, including amalgamation, demerger, consolidation or any other kind of corporate restructuring falling within the scope of section 391 of the Companies Act, 1956.

✿ **The Policy Initiatives That Have Been Undertaken In The Primary Market During The Recent Years :**

✿ SEBI has notified the disclosures and other related requirements for companies desirous of issuing Indian depository receipts in India.

✿ As a condition of continuous listing, listed companies have to maintain a minimum level of public shareholding at 25 per cent of the total shares issued.

✿ SEBI has specified that shareholding pattern will be indicated by listed companies under three categories, namely, '*shares held by promoter and promoter group*'; '*shares held by public*' and '*shares held by custodians and against which depository receipts have been issued*'.

✿ SEBI has facilitated a quick and cost effective method of raising funds, termed as '*Qualified Institutional Placement (QIP)*' from the Indian securities market, by way of private placement of securities or convertible bonds with the Qualified Institutional Buyers (QIP).

✿ To regulate pre-issue publicity by companies, which are planning to make an issue of securities, SEBI has amended the '*Disclosure and Investor Protection Guidelines*' to introduce '*Restrictions on Pre-issue Publicity*'. The restrictions, inter alia, require an issuer company to ensure that its publicity is consistent with its past practices, does not contain projections/ estimates/ any information extraneous to the offer document filed with SEBI.

✿ **The Policy Initiatives That Have Been Undertaken In The Secondary Market :**

✿ A comprehensive risk management system was put in place since May 2005. The stock exchanges have been advised to update the applicable Value at Risk (VaR) margin at least 5 times in a day, by taking the closing price of the previous day at the start of trading and the prices at 11:00 a.m., 12:30 p.m., 2:00 p.m. and at the end of the trading session. This has been done to align the risk-management framework across the cash and derivative markets.

✿ In order to strengthen the '*Know Your Client*' norms and to have a sound audit trail of the transactions in the securities' market, '*Permanent Account Number (PAN)*' was made mandatory with effect from January 1, 2007 for operating a beneficiary owner account and for trading in the cash segment.

CONCLUSION

The capital market plays a vital role in fostering economic growth of the country, as it augments the quantities of real savings; increases the net capital inflow from abroad; raises the productivity of investments by improving the allocation of investible funds; and reduces the cost of capital in the economy. The basic objective of setting up a financial sector regulator by a country is to safeguard the country's financial system from risks, to protect the investor's interests and promoting competition across the financial system by curtailing the monopoly power yielding by the financial conglomerates. The emergence of corporate governance is due to the prospective conflicts of interest among participants involved in the entire process, i.e., stakeholders in the corporate structure.

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