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Corporate Governance in India: Understanding the History and Peeking into the Future

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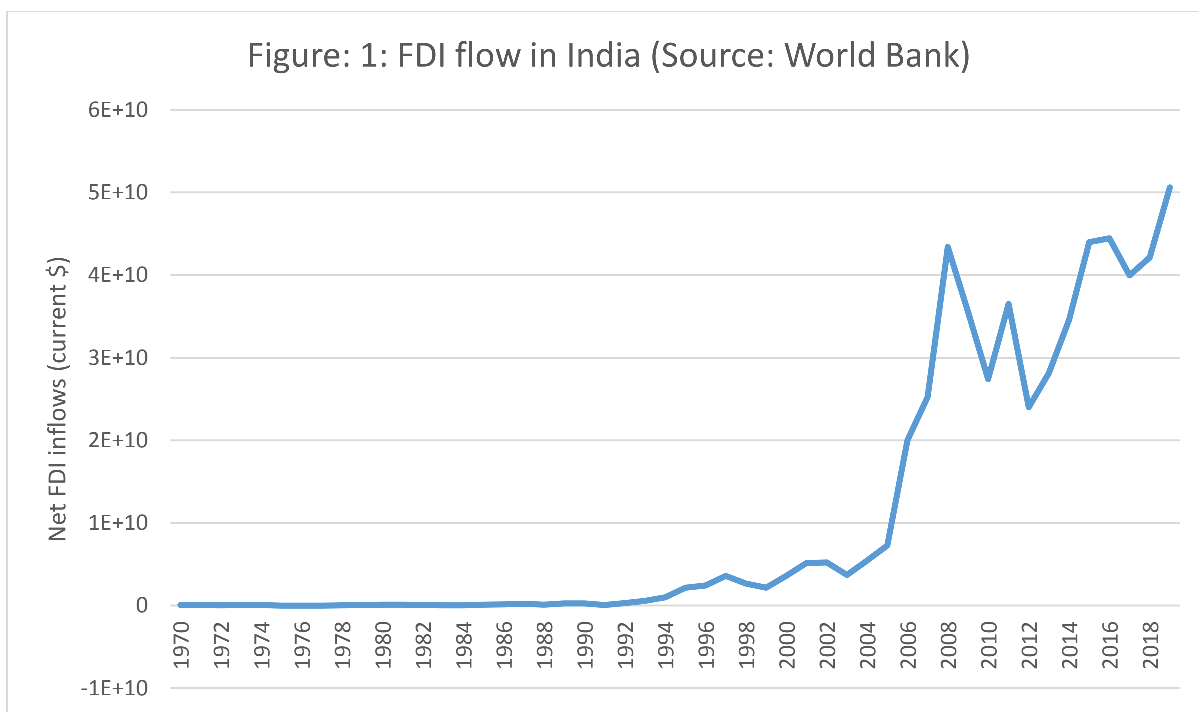
(This article is Part II of the essay. Part I dealt with corporate governance practices in India from the colonial period until the command capitalism – 1950 to 1990 – period; it was published in the previous issue of Artha. Part III will be published in the next issue.)

CORPORATE GOVERNANCE POST ECONOMIC LIBERALISATION

With Economic liberalisation in 1991 India ushered into the market economy from a command economy. Indian economy got integrated with the world economy. It opened up new opportunities and transformed the sellers' market to buyers' market with easy availability of foreign consumer products. The government dismantled the license raj, opened up most sectors (including the infrastructure sector) for the private sector enterprises, and liberalized foreign investment in Indian companies through foreign direct investment (FDI) and foreign portfolio investment. All those policy changes opened up new avenues for Indian business and a vast Indian market for foreign multinationals. Although the government adopted the policy of privatisation of or disinvestment in public sector enterprises (PSE), existing PSEs continue to occupy dominating position and securities some of the large well-run PSEs have been listed in stock exchanges.

During this period, business groups diversified into sectors that were earlier reserved for state-owned enterprises and new business groups emerged. For example, the growth of Reliance Industries Limited (RIL), which was established by ambitious Dhirubhai Ambani in 1973, accelerated only after 1991. Adani group, which was established in 1988, is a name to recon in the infrastructure sector. Another example is the Bharti group, which was incorporated in 1976. It established Bharti Airtel in 1995, which is now among the top three telecommunication companies in India. During this period, multinational companies either established their subsidiaries or collaborated (such as through joint ventures) with Indian companies to enter the market. In 1992 the government allowed FPI in Indian companies and FDI norms are being relaxed gradually. Figure 1 shows that the inflow of FDI has increased sharply starting from 2004.



The opening up of the economy also increased competition in the product market and managerial labour market. This resulted in the reversal of the trend of unrelated diversification (demerger and disinvestment) and started the merger and consolidation of related businesses.

Capital market reforms

Securities and Exchange Board of India (SEBI), which was established in 1988 as a non-statutory body, became an autonomous body on 12 April 1992. It was accorded statutory powers with the passing of the SEBI Act 1992 for protecting the interests of investors in securities and promoting the development of the securities market and regulating the same. Capital Issue Control Act was repealed, and the control over volume and pricing of capital

issues was abolished. SEBI initiated several reforms after the mega security scam in 1992 perpetrated by Harshad Mehta, a stockbroker. SEBI's regulations are comparable with those in advanced economies.

National Stock Exchange (NSE), the digital stock exchange, was incorporated in 1992 and was recognised as a stock exchange by SEBI in April 1993. In 1995, the Bombay Stock Exchange (BSE) switched from an open cry floor trading system to an electronic trading system. The Indian capital market, particularly the equity market (cash segment) has grown significantly after the liberalisation (Acharya, 2019). Acharya (2019) reported that "segments of the Indian capital market are comparable with counterparts in many of the advanced economies in terms of efficiency (price discovery), tradability (low impact cost), resilience (co-movement of rates across product classes and yield curves), and stability."

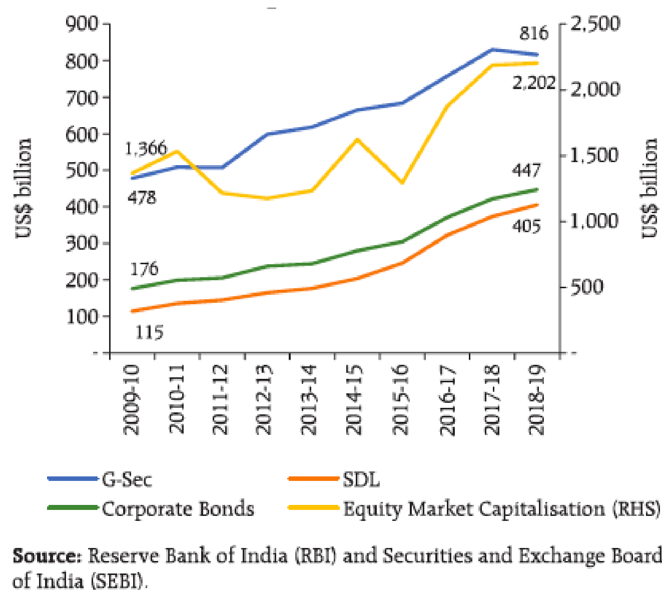


Figure 2: Growth of the Indian capital market (Source: Acharya, 2019)

Indian code of corporate governance – the emergence of the monitoring board

Only in 1976, the term corporate governance, the concept of monitoring Board and audit committee surfaced in the U.S.A. (Cheffins, 2013). Earlier the Board of directors in the U.S.A. was a management board. Top executives strongly influenced the selection of directors, and the Board was expected to be collegial and supportive to the management. It acted only in a situation of outright crisis. The concept of corporate governance and monitoring board caught the imagination of the government and stock market regulators of countries – other than the U.S.A. and the U.K.– after the Cadbury Committee in the U.K. submitted its report in 1992. The Committee incorporated its recommendation in the Code of Best Practices, which became the model for developing a code of corporate governance in different countries. India was no different. SEBI, for the first time, issued the code of corporate

governance in 2000. Stock exchanges, under the direction of SEBI, incorporated the Code of corporate governance in the Listening Agreement (Clause 49). This is the first time that the listed companies were required to induct independent directors on their board and the boards to form an audit committee. Earlier, boards in India were similar to the boards the U.S.A. had prior to 1976. The Code of corporate governance failed to improve the functioning of the boards and corporate governance did not improve. Boards got transformed into ornamental boards with big names, who used to lend their names. Promoting families invest money, time and emotions in the company. They do not like outsiders to interfere in the management of the company. Therefore, they select independent directors known and r sympathetic to the promoter family and the senior management. Most companies take the 'tick-the-box' approach to comply with the corporate governance regulation.

Clause 49 was revised many times, and in 2015, it was replaced by the SEBI (Listing Obligation and Disclosure) Regulation 2015. This too was revised on many occasions to incorporate emerging global best practices. Every board is now required to constitute the Nomination and Remuneration Committee, but it does not function independently of the controlling shareholder. The question, 'how independent are independent directors' continues, although the Companies Act 2013, which came into force on April 1, 2014, includes several provisions for strengthening the institution of independent directors. It also introduced audit reforms like the rotation of auditors in order to protect the interest of the company and minority shareholders.

CURRENT STATE OF GOVERNANCE

The corporate landscape

The National Stock Exchange (NSE) is ranked as the third largest stock exchange globally in terms of the number of equity trades, as per the World Federation of Exchange (WFE) Report - 2019. NSE has over 1900 securities listed on NSE with a market capitalisation of over Rs 154.32 lakh Crores (U.S. $ 2.10 trillion), as of Dec 2019. The NIFTY 200 Index represents about 86.7% of the free-float market capitalization of the stocks listed on NSE as of March 29, 2019.

I have analysed the shareholding pattern of companies in the NIFTY 200 index for understanding the composition of the types of firms included in the index and getting insights into the shareholding pattern of those companies. There are various definitions of family business (Diaz et al., 2019). Researchers use various characteristics to define family business, and most use the ownership of ordinary shares and membership in the board of directors. International studies on corporate ownership typically establish some minimum control threshold such as 5%, 10%, or 20% (Villalonga, 2010). La porta et al. (1999) define a controlling shareholder as having more than 20 percent voting rights. Using the 20 percent threshold, I have classified a company as family-

controlled if the promoter holding is 20 percent or more. I have used the term professionally managed companies for other companies (i.e., companies with promoters holding less than 20 percent of shares). I have also treated the subsidiaries of professionally managed companies as professionally managed companies.

The Nifty 200 index has 114 family-controlled companies (57%), 23 subsidiaries of multinationals (11.5%), 28 professionally managed companies (14%) and 35 state-owned enterprises (17.5%). If we go by the narrow definition, which uses an additional parameter in defining family business – the business should continue in the second generation, a few companies cannot be classified as family-controlled companies as they are controlled by the first-generation entrepreneur.

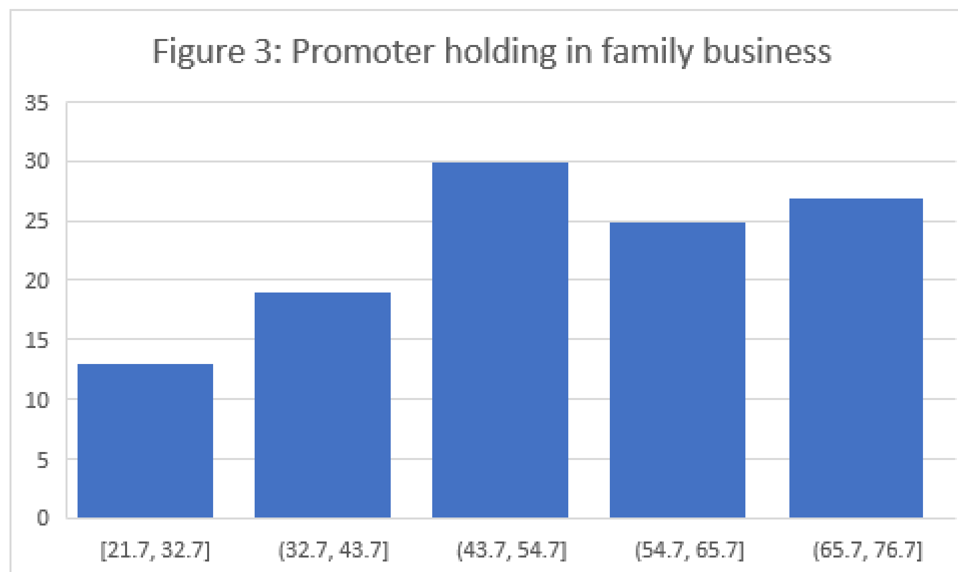


Figure 3 shows that the promoters are tightening their grip on the companies controlled by them. However, some promoters are selling their shares to multinationals, venture capitalists and asset management companies. For example, ACC and Ambuja Cement were acquired by Lafarge Holcim 1n 2017. In 2016, New-York based Blackstone, an Alternate Asset Management company, acquired a 60.5% stake in IT service firm Mphasis Limited and subsequently sold 8 percent. Again in March 2020, it acquired 4.01 percent shares of the company. At present, it holds 56.21 percent shares of Mphasis. Another example is Crompton Greaves Consumer Electricals Limited. This company was born in 2016 when Crompton Greaves Limited (a Karan Thapar Group company) demerged the consumer goods business from power and industrial systems segment. Its September 30, 2020, shareholding report shows three foreign body corporates (promoters) are holding 26.19 percent voting rights.

Startups

As per Hurun Research Institute's 2020 Report, India has 21 unicorns with an average age of seven years (two are less than four years old) and a total valuation of $73.2 billion. As per the report, almost all promoters

of these 21 unicorns are IIT and/or IIM graduates and some have completed their education in universities abroad.

Usually, the promoters enjoy the venture's growth and share only a small portion of the enormous wealth they create. A case in point is Housing and Development Finance Corporation Limited (HDFC). At the age of 65 years, H.T. Parekh set up HDFC in October 1977, when the concept of housing loan was unknown in India. ICICI promoted the company. Deepak Parekh, the nephew of H.T. Parekh, nurtured HDFC and retired as its chairman in 2009 holds just 0.7 percent of the voting rights (Times of India, 2020). At present, HDFC has no promoter. The company and its three subsidiaries are included in Nifty 200.

Institutional investments

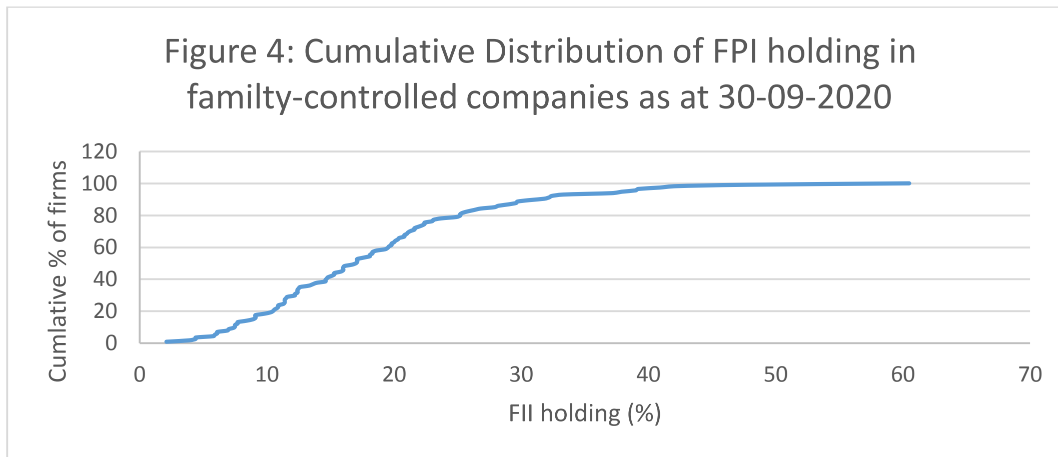
The interest of foreign portfolio investors (FPI) in the Indian market is increasing. It is evident by the number of FII registered with SEBI. It was 997 at the end of 2006-2007 and increased to 9,136 at the end of 2017-2018. The research concludes that foreign portfolio investment improves corporate governance (Aggarwal et. 2011; Gillan and Starks, 2003). I have examined the percentage of foreign portfolio investment in different types of companies. Table 1 below provides a summary of the shareholding pattern of Nifty 200 companies.

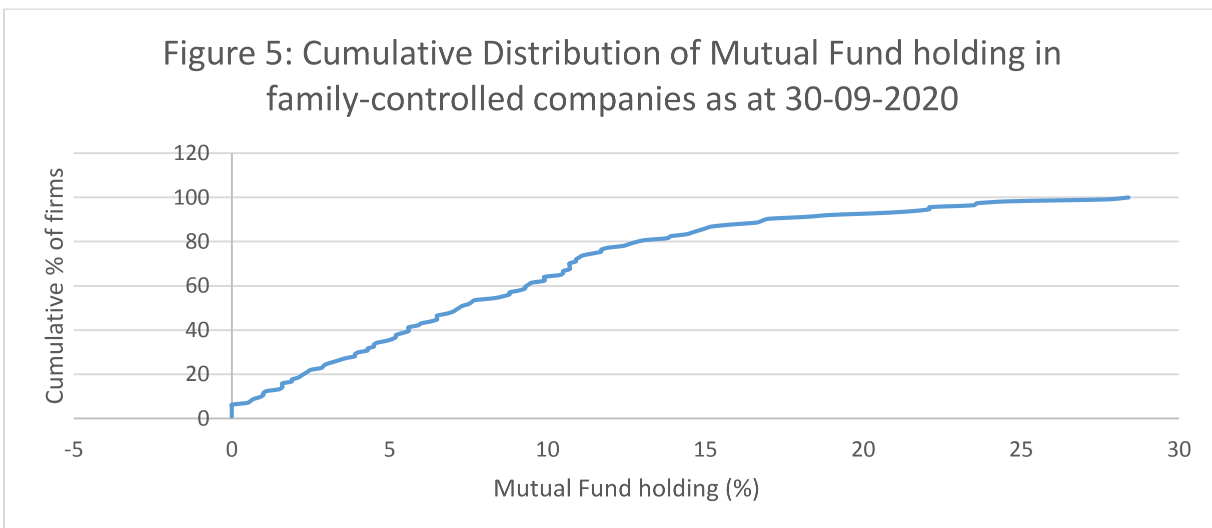
Table 3: Shareholding pattern Nifty 200 companies as at September 30, 2020

	Family-controlled companies (percentage)		Professionally managed companies (percentage)		Public sector enterprises (percentage)		Multinationals (percentage)	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
Foreign portfolio investment (FPI)	18.40	17.05	26.40	22.80	11.07	7.70	10.91	10.70
Mutual Fund	8.46	7.25	10.80	9.50	7.61	7.10	6.98	6.20
Total	**26.86**		**37.20**		**18.68**		**17.89**	
Other institutions	4.53	3.90	9.20	5.80	8.24	6.40	6.67	6.80
Total institutional investment	**31.40**	**28.20**	**46.40**	**51.20**	**26.91**	**29.20**	**24.57**	**25.40**
Public	15.47	12.85	20.50	14.30	11.27	9.10	13.20	13.10
Promoter	52.95	53.55	32.80	26.20	61.80	57.60	62.24	62.80
Total*	**98.8**		**98.7**		**100.0**		**100.0**	

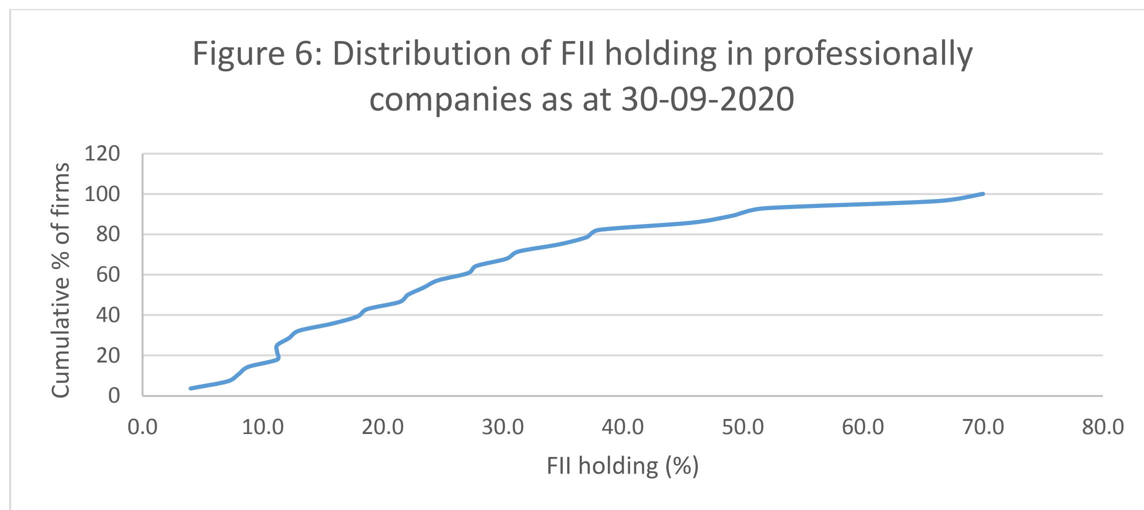
* variation from 100 is due to approximation; Source: Compiled by the author

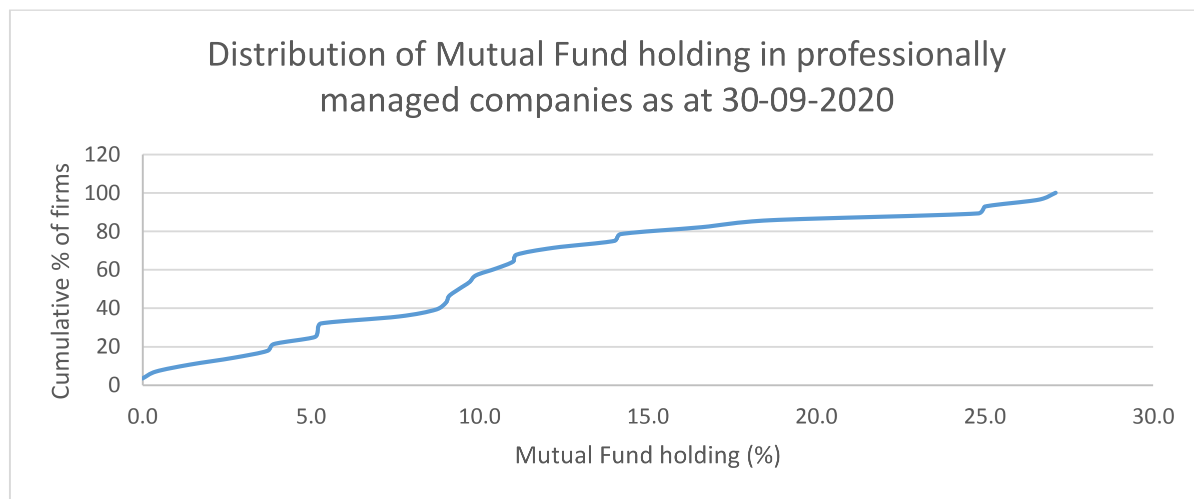
Table 1 clearly indicates that the average FII shareholding in family-controlled companies (18.40 percent) is non-trivial and total institutional holding at 31.40 percent is significant. Therefore, intuitional shareholders together can influence the corporate governance practices in family-controlled companies. However, FPI holding was less than 15% in around one-half of all family-controlled entities included in the Nifty 200 index percent(see figure 4).





Average FPI holding in professionally managed companies is significant (26.40 percent), average total institutional holding is very substantial (46.40 percent). However, around 35 percent of the professionally managed companies have less than 15 percent of FPI investment (see figure 6).





Code of corporate governance

Indian corporate governance code (CG Code) embedded in the SEBI (Listing Obligation and Disclosure) Regulations 2015 is a hard law (comply or else), whereas, in the U.K. and some other countries, it is a soft law (comply or explain). SEBI tracks the emerging global best practices and incorporates them in the CG Code without delay. CG Code was last revised in 2019.

In September 2017, the government amended the Companies Act 2013 to restrict step-down subsidiaries to two. In counting the number of subsidiaries, one 100 percent subsidiary will be excluded. A company may have as many direct subsidiaries as it desires. The new rule is applied prospectively. Therefore, companies are not required to close down existing step-down subsidiaries. Although the primary aim of this rule is to plug the loophole for

money laundering through shell companies, it will stop the use of the pyramid structure for controlling companies with low cash flow rights.

The government created the National Financial Reporting Authority (NFRA) in October 2018 with a broad authority to oversee the auditing profession and punish the auditor found guilty of negligence. NAFRA has already taken penal actions against partners of one of the Big 4 firms. Effective from April 1, 2018, all listed companies must apply Indian Accounting Standards (Ind AS), which is a clone of International Financial Reporting Standards (IFRS). Indian Standards of Auditing are aligned with the international standards of auditing. Those initiatives have improved the quality of financial reporting and audit quality leading to improved corporate governance.

In India, Stewardship Code has been implemented effective from July 1, 2020. Under the code, institutional investors need to monitor investee companies and intervene in their governance through meetings with the management. Also, they need to have a policy on voting and disclose the voting behaviour.

SEBI mandated responsibility reporting by top 100 listed companies from 2012, top 500 listed companies from the financial year 2015-2016, and top 1,000 listed companies from the year 2019-2020. In 2017, SEBI recommended Top 500 companies to use of the Integrated Reporting <IR> Framework for annual reporting.

Awareness has been created about the benefits of good corporate governance. Some companies have good governance practices. Still, many companies have adopted the 'tick-the-box' approach in implementing the code of corporate governance. The institution of independent directors has remained weak and demand for management-sympathetic independent directors continues. Most boards are somewhere between 'rubber stamp board' and advisory board. The Satyam scam (2009), Kingfisher airlines failure (2012) and IL&FS scam (2018) brought to the surface the poor corporate governance practices in companies in which big names were board members. It is not that the board members colluded with the management. They did not fulfill their responsibilities of applying due diligence while approving financial statements or strategies proposed by the controlling shareholder. The auditing profession is adjusting to the new reality that they can no more act as a friend, philosopher, and guide of the management. Shareholders, regulators and society expect the auditor to be their friend and demonstrate a very high level of independence. Family-controlled companies are yet to come out of the hangover of the managing agency system fully. However, the change is visible. India is at the cusp of transformational changes in corporate governance.

In a nutshell

In 1991, India transited from the command economy to the market economy: Licensing raj was dismantled; the capital market has been reformed to make it comparable with the capital markets in advanced countries in terms

of efficiency. FDI and FPI are encouraged; and the sellers' market has been transformed into the buyers' market. A corporate governance code with the best corporate governance practices has been implemented. The government has taken initiatives to improve the accounting and audit quality. A new corporate law (Companies Act 2013) has been enacted and the government and regulators have taken steps to strengthen the institution of independent directors. Moreover, the companies are now operating in a competitive environment and FPI investment in Indian companies has increased.

All these measures have improved the corporate governance practices in only some of the companies. In general, the family-controlled companies are yet to implement the corporate governance code in spirit. They have taken the tick-the-box approach and look for management-friendly independent directors. In most companies, the audit committee may be working at less than the desired level and the Nomination and Remuneration Committee may be the most underrated committee. Still, a change towards the better is visible, and India is at the cusp of a transformation in corporate governance.

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