G Padmanabhan: Governance in the corporate sector – certain perspectives

Valedictory address by Mr G Padmanabhan, Executive Director of the Reserve Bank of India, at the 15th National Conference of Practising Company Secretaries (PCS) on the theme "Practising Company Secretaries: The Facilitator for Corporate Growth", Mumbai, 27-28 June 2014.

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1. Mr. Sridharan, President, Institute of Company Secretaries of India (ICSI), Mr. Khare Vice-President, Mr. Sahoo, ladies and gentlemen. Good afternoon. It is my pleasure and privilege to address this gathering today at the conclusion of the 15th National Conference of Practicing Company Secretaries (PCS) held under the aegis of ICSI. When my good friend Mr. Sahoo asked me to address this august gathering, I accepted with alacrity since I am aware that the ICSI has been dedicating itself to developing and regulating the profession with its vision of being a global leader in promoting good corporate governance and a mission to develop high caliber professionals to facilitate good corporate governance. I respect that. ICSI is also nurturing professionals that are actively engaged in issues to enhance governance in the corporate sector as well as in the securities markets, the two vital growth engines of the economy. I applaud that. Companies or corporations have been the principal way of organising large scale commercial or industrial endeavour right down the history but it assumed a formal structure in the early nineteenth century as the industrial revolution gathered pace[1]. The story of growth and development since then in the free-market economies is not very different from that of the evolution of corporations. The narrative is not very different in India. The corporate sector has registered a quantum change in terms of size, number and complexity over the years and is slated for further acceleration in the process in the times to come. Therefore, today, the importance of a strong and vibrant corporate sector in the economic growth process cannot be overemphasised.

2. The profession of a company secretary is probably as old as companies themselves. Though it has greatly evolved over the time, the nucleus continues to be "compliance". A company functions in the milieu of a maze of regulatory obligations. The job of a company secretary - whether as an employee or a practitioner - is to ensure that the company functions within the ambit of the legal and regulatory framework. As Lord Cadbury observes in his now eponymous report, "The chairman and the board will look to the company secretary for guidance on what their responsibilities are under the rules and regulations to which they are subject to and on how those responsibilities should be discharged." To complete the perspective, let me also quote the then Central Minister Shiv Shankar, who stated, while introducing the Company Secretaries Bill, 1980, "The Government attaches special importance to the development of professional management, so that the corporate sector can evolve and function in tune with changing needs of time, and the social responsibilities that this important segment of the economy has to shoulder. The profession of Company Secretaries has an important part to play in the introduction of professionalism in the area of corporate management."

3. During the past two decades, the importance of good corporate governance has come to the fore. The concern has been reinforced, particularly as it relates to the financial sector, in the backdrop of the global financial crisis. Suffice it to say here that it essentially comprises acting in a manner as to enjoy sustained trust of all the stakeholders which can broadly be

[1] It may be of some interest to note that the so called Bubble Act, 1720 had banned formation of all companies in UK without a Royal Charter till it was repealed in the wake of progress of industrial revolution.

grouped into four categories: the owners, the lenders, the customers and the regulators. The literature on corporate governance is voluminous and I too have spoken about it elsewhere. It is not my intention to go into the principles and practice of sound corporate governance here today. After jogging my mind about the issues that I should flag to an audience like this, I concluded that, given my background, it might be worthwhile to talk about the tension between the companies and regulators, and then about some of the changes brought about by the new Companies Act and my perception about a few important areas. Let me start with the tension between the companies and the regulators, why it is important to resolve this and establish synergy in the interest of corporate and economic growth and how it can be achieved.

4. One of the themes often discussed these days is the ease of doing business. According to global ranking of 189 countries published by the World Bank in June 2013, India figures at rank 134 in the overall ease of doing business, at 179 in the attribute “starting a business”, at 186 in “contract enforcement” and 124 in “resolving efficiency”. Not an insignificant part of the blame for this predicament usually is laid at the door of the complexity and opacity of the regulatory framework. Without admitting the truth of the accusation or culpability as a regulator, I have no hesitation in stating that both the regulatory framework and its administration require improvement. At the same time, let me argue that this improvement is not possible at the initiative of the authors and administrators of regulations alone; it requires active contributions from those for whom the regulations are framed. This is where you have an important role to play.

5. What is the foundation of regulations? In a free market economy, regulations are basically aimed or should be aimed at addressing various reasons for market failure: existence of monopoly power, externalities, information asymmetry etc. Put another way, in a kind of “bar stool” manner, regulations are aimed at addressing the divergence between individual and social incentives. There are many parables that illustrate this point; let me do this with the so called “tragedy of commons”. Suppose residents of a village use a parcel of land – called common in UK – to graze their animals. If one villager grazes an additional animal, it is beneficial for her but detrimental for villagers as a group. If several villagers do this, the common will be depleted and ultimately destroyed. Societies down the ages have resolved this problem in myriad ways – mostly through standards of normative behaviour rather than regimes of regulations and their enforcement. In a modern economy that is large, complex and organically interrelated, such problems require elaborate and explicit rules and regulations and their administration and enforcement.

6. Regulations thus are supposed to modify behaviour of those covered by the regulation and ensure that they behave in a socially desirable way. But whether the regulations will have to be in the nature of a nudge or a shove depends upon how the regulated entities respond to. When the regulations are simple and the regulated entities comply with the regulations in letter and spirit so that the objective of the regulator is achieved, it is not necessary for regulations to be complex and detailed, which makes both administration and compliance difficult. In addition, several socially and economically useful activities may also not be undertaken in the face of such elaborate regulatory regimen.

7. Let me give an example from my own professional field. As you are aware, we have restrictions on capital account transactions. This is motivated by the objective of macroeconomic stability. In the preference hierarchy of capital inflows, equity inflows dominate debt inflows and as such we have a stricter regulatory regime for debt in comparison with equity. In 2007-08, when the global market conditions were benign and the Indian economy was going at a rapid pace, there were large debt inflows resulting in Rupee appreciation. Reserve Bank’s efforts to contain the Rupee volatility in turn resulted in large Rupee liquidity which had to be sterilised at considerable fiscal cost lest inflationary pressures became unmanageable. In the circumstances, the regulatory framework discouraged borrowing by Indian companies. I don’t need to amplify that this measure was in the greater interest of the economy including that of the companies. It would have been the

end of a nice story if the companies had moderated their foreign currency borrowings in response to these regulations.

8. But how did the companies respond? Let me elaborate three different ways in which they tried to circumnavigate the regulation with the caveat that there may be others.

a. Some companies issued convertible debentures, which, till 2007, was a permitted instrument for equity investment. But such debentures were structured in such a way that they were predominantly debt rather than equity. As an example, in a convertible debenture of 100 Rupees, only 10 Rupees were convertible to equity on maturity.

b. Some others adopted a slightly more sophisticated approach. They issued equities with a put option at a specified strike price in favour of the investor thus camouflaging the debt nature of the instrument. To illustrate, suppose an equity instrument valued at 10 Rupees is issued with a put option after five years with a strike price of 20. At the appropriate time, the investor exercises the option and sells back these shares at Rupees 20 to the issuer, thereby getting a fixed return of close to 15 per cent. The economic essence of the whole transaction is that the company has borrowed the funds at a cost of 15 per cent.

c. Yet others adopted an innovative approach. A company issues a share valued at 10 Rupees at a premium of Rupees 25,000 and enters into a shareholders' agreement promising a guaranteed dividend of 8 per cent on the face value of the share as well as the share premium. The structure needs no elaboration.

9. What does the regulator do when such incidents unfold? They respond by making regulations more elaborate and provide for clauses that can prevent the aforesaid evasions. The regulatory framework evolves in a process of a game continuously played between the regulator and the regulated entities. What is necessary in the larger interest of the economy is that these games result in improving the common good.

10. I now come to the second part of my address, the new Companies Act. I consider the enactment of the new Companies Act 2013 (CA 2013) as an important development. As we all know, the new law introduces changes and updates to various aspects relating to companies and their operations, including accounting, auditing, corporate governance, related party transactions, loans and investments, mergers, reconstruction and raising of capital. The updates necessitate changes and enhancements in the role of practicing company secretaries going forward. I understand that these issues, in particular with regard to the conduct of secretarial audit, have been deliberated upon in various sessions held over the last day and a half. On my part, permit me to talk about certain provisions relating to three aspects of the CA 2013 viz. the Board, the audit function and corporate social responsibility; all areas that impact corporate governance by default, the growth and development of an entity and the economy by consequence.

The board of directors

11. Recognising that the Board of Directors is the ultimate source of governance in a company, the new CA 2013 addresses the issues relating to its composition of the and functioning comprehensively in order to enhance its efficacy. The Act specifies that each company should have at least one "resident" director who has stayed in India for a total period of not less than 182 days in the previous calendar year. Large companies will also need to have at least one woman director on the Board and listed companies should have at least one third of the Board as independent directors. Independent directors can hold office for not more than two consecutive terms of five years each. The number of Board memberships a director can hold in public and private companies is also limit bound. Board meeting can be called only after a seven day notice and the fiduciary duties of directors are

clearly defined in the Act. The code of conduct for independent directors has been appropriately articulated.

12. The Act also makes it mandatory for all listed companies and certain other companies to put in place an Audit Committee and a Nomination and Remuneration Committee. The type of directors that can be members of the Committees are specified with thee scale weighing in favour of independent directors. The responsibility of chairing these Committees can be assigned to persons competent and qualified to discharge the responsibility.

13. The above provisions will ensure diversity and integrity in the composition of the Board/Committees and facilitate the company in benefiting from available talent pools. These improvements in turn will ensure effective Board oversight, inculcate operational discipline and instill financial discipline, leading to overall improvements in the corporate sector.

Audit function

14. Paraphrasing Wendell Phillips, we can say that effective audit is the price of good governance. In the area of audit, the CA 2013 provides for various checks and balances to ensure that the audit function in the corporate world maintains impeccable quality. The appointment of individual auditors and audit firms cannot exceed five consecutive years or two terms of five consecutive years, respectively. The appointment will be subject to ratification at every Annual General Meeting (AGM) and similarly, their removal prior to a five year term will also be subject to a resolution at the AGM and government approval, where required. There are stiff penalties and provisions for prosecution by the National Financial Reporting Authority for fraudulent actions on the part of the audit firms. The act also prohibits auditors from providing non-audit services such as book-keeping, internal audit, actuarial services, investment advisory services, etc. to the company where they are auditor to ensure their independence. These measures will not only ensure quality in audits but will also bring more transparency and accountability for the auditors as well as the company.

15. This brings me to an important provision in the Act, relating to the introduction of "Secretarial Audit" as a new class of audit, in addition to the existing mandated statutory audit, internal audit and cost audit. Secretarial audit will be mandatory for listed companies and certain other specified companies viz. those public companies that have paid up capital of Rs 50 crore or more or a turnover of Rs. 250 crore or more. In the CA 1956, the requirement was only to file a compliance certificate given by a PCS with the Registrar of Companies with the requisite fees and attach a copy with the Board's report. This will no longer be the case. The objective of the proposed secretarial audit under CA 2013 will be to improve the compliance culture in the corporate sector in letter and spirit, and ensure transparency and timely communication of compliance/non-compliance status to the management of the company, regulators and external stakeholders. This will ultimately protect the interest of customers, employees, directors, stakeholders and avoid any unwarranted action from the law enforcing /other agencies. The report of the secretarial audit will need to be annexed with the Board report. The Board of Directors in their report to shareholders will need to explain any qualification/remark made by the company secretary in practice in the secretarial audit.

16. The secretarial audit is intended to be a detailed and meaningful exercise conducted by a professional to verify compliance with provisions of various laws applicable to a company. It is you, practicing company secretaries who will have the responsibility to conduct these audits for which you will have similar powers and rights as statutory auditors. In fact, practicing company secretaries will form part of the Key Management Personnel (KMP) of certain class of companies whose appointment, remuneration and removal can only be effected through Board resolutions. Given the significance of the position and the work involved in the audits, it will be important to ensure that practicing company secretaries inculcate the required expertise and knowledge to conduct these audits diligently and with

integrity. This will benefit the company management, government authorities, regulators, investors as well as other stakeholders with positive effects spreading to the economy.

Corporate social responsibility

17. "The price of greatness is responsibility", Winston Churchill often used to say. There is no reason why it should be any different for companies as well. A new initiative that has been put in place under the CA 2013 relates to corporate social responsibility (CSR) of companies. Under the Act, every company with net worth of Rs 500 crore or more, or turnover of Rs 1,000 crore or more or a net profit of Rs 5 crore or more during any financial year will need to set up a CSR Committee, which will, inter alia, recommend to the Board an appropriate CSR policy, indicate the CSR activities that the company will undertake and recommend the amount of expenditure to be incurred on the activities. Boards of CSR companies will need to ensure that at least 2% of the average net profits made during the three immediately preceding financial years are utilised for CSR activities, giving preference to local area and areas around where it operates. In case of non-fulfilment of CSR spending, the reasons will need to be indicated in the report of the Board in a "comply or explain" approach. The CSR policy and its contents will also need to be disclosed in the Board report and the company's website.

18. Thus far, there had been no specific mandate for CSR for companies, though several companies did voluntarily undertake CSR initiatives. With the new Act, CSR activities will be a responsibility of all specified companies. While there may be issues in implementing CSR initiatives in companies that have not yet ventured in this area and also for companies with large amounts becoming eligible for CSR spends, over time this measure will not only help in the economic and social progress of the under privileged sections of the society but also facilitate gains for companies in terms of their reputation and image.

The profession

19. I have talked about some key provisions of the CA 2013 that are likely to have a positive bearing on the governance and compliance culture in the corporate world. However, simply enshrining the provisions in the Act will not ensure that governance standards are enhanced. The key in my view lies in their appropriate implementation, which will need to be ensured. Towards this end, the Act has significantly enhanced the role of company secretaries. As a professional class, PCS will in the year ahead, need to emerge as an extremely reliable source of assessing existing or potential compliance risks in the corporate sector; a source whose integrity will be relied upon by various regulators and agencies, and indeed the corporate sector itself. So, what needs to be done? Where does the profession see itself going forward and how does it get there?

20. To answer the questions, let me go back to some issues relating to the roles and responsibilities of PCSs. The conduct of the annual secretarial audit that PCSs will have to perform going forward will entail i) reporting to the Board about the compliance with the provisions, rules and laws applicable to the company, and ii) ensuring compliance with the secretarial standards, as issued by ICSI. These two functions will cast an overwhelming responsibility on PCSs that will require them to incur knowledge and experience of various laws, regulations and practices on the one side and display commitment and integrity in performance on the other.

21. To illustrate the enormity and depth of the task entrusted to PCSs, the scope of the secretarial audit will include assessing a company's compliance with all applicable provisions of the CA 2013, SEBI Act 1992, RBI Act 1934, Securities Contracts Act 1956, Depositories Act 1996, FEMA 1999, Competition Act 2002, listing agreement and any other law specifically applicable. Compliance with various secretarial standards issued by the ICSI to aid companies in discharging their corporate responsibilities will also need to specifically assess as these standards, several of which are non-financial, have been provided statutory

recognition in CA 2013 as against their earlier recommendatory nature. Further, the secretarial standards cover the entire range of company operations including conduct of meetings, dividends, shares, maintenance of records, inter-corporate interactions, contracts, appointment of auditors, etc. which PCSs will need to assess.

22. I understand that the ICSI will be embarking upon a nationwide capacity building exercise amongst the existing professionals and members to meet the expectations and requirements of the enhanced position of PCS under the new Act. In addition, to bring up a niche cadre of high quality professionals in the coming years, the Institute also plans to initiate a long duration integrated programme for company secretaries. These initiatives are timely and warranted, and if I may say so necessary for developing world class professionals who will facilitate corporate sector growth through their knowledge, expertise, guidance, analysis and insights. These formal capacity building initiatives will, however, need to be supplemented with self-motivated learning as well as regular interactions with companies, regulators, government agencies and other stakeholders to understand organisational issues, compliance requirements and disclosure rationales. Practicing company secretaries will soon move to the centre of the corporate world. It is imperative that they are geared for this enhanced role.

Conclusion

23. Let me conclude by summarising the issues that I have touched upon today. I raised the issue that what is often good for an individual may not always be good for the society which explains the difference in perception between the regulator and the regulated. Thereafter, in the context of the new Companies Act 2013 and some of its important provisions in relation to corporate governance, I talked about i) the changes that will need to be effected in the Boards of companies, particularly listed companies as also certain other companies and the beneficial effect these are likely to have on corporate sector's operations and growth; ii) the improvements proposed in the audit function, in particular the introduction of secretarial audit and its importance in creating compliance awareness for management and external stakeholders; iii) the new provisions relating to social responsibility of the corporate world and its role in facilitating (sustainable) growth in the economy and lastly, iv) how the profession of company secretaries needs to evolve going forward to meet the challenge of a more pivotal role in the corporate sector. In my perspective, the Companies Act 2013 proposes significant improvements in the corporate sector operations and casts huge responsibility on company secretaries; it is for you professionals to live up to the enhanced expectations and responsibilities that will now be coming your way and ensure that the proposed improvements come to fruition. My best wishes to the Institute in its continued endeavours to bring about a more vibrant, ethical and responsible corporate India.

Thank you.