The Ethical Corporation
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Lecture - 18
Specific Areas of Concern in Corporate Governance and Countermeasures - I

We are back; we are back more with more on Corporate Governance, this is our lecture 18; on our 4th week. And we are going to talk about specific areas of Concern in Corporate Governance and how to address this, what are the countermeasures. I have to tell you that the subject of the topic of corporate governance is enormously complex and it is quite vast, but I have tried to keep it accessible keeping in mind that there might be different kind of participations and for this course.

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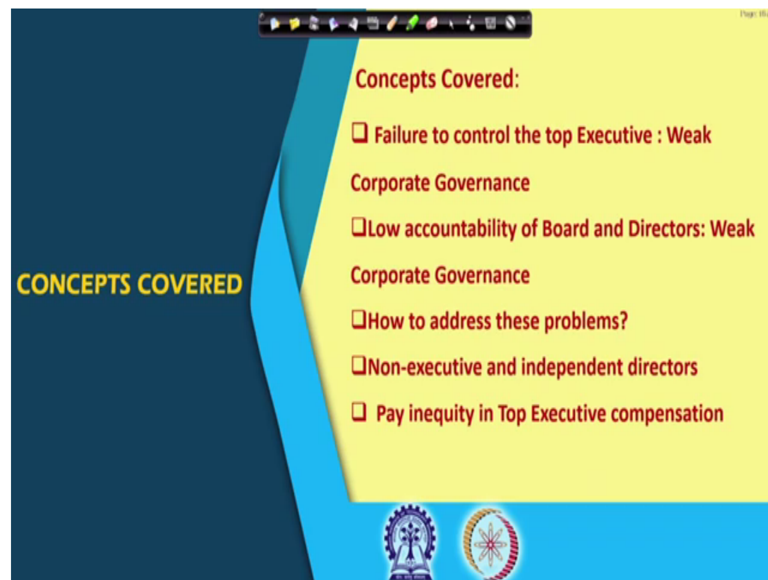

So, I hope this is all accessible to you. We are going to talk about today as I said where the specific problems lie and how to address those problems.

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- The major issue is: Investor's interest protection, and protection of the rights of the shareholders (Monks and Minnow 2004). E.g. Right to certain key information about the company, right to take action against the managers or the company for any misconduct.
  - Protection of minority shareholder's rights

Weak corporate governance can create major concern in these specific areas :

1. Top Executive accountability and control
2. Top Executive remuneration
3. Issues related to Mergers and Acquisitions
4. External systemic issues: Role of financial markets and insider trading, Role of auditors and audit firms, and market intermediaries

See the major issue in corporate governance remains the same; namely we are talking about how to protect the investors interest. Because it is an agency problem I have said that or how to protect the rights of the shareholder; as the literature has talked about. And I have shown that the issue is also at times when there is majority and minority shareholders how to protect the minority shareholders rights.

But corporate governance failures show up in certain areas very prominently and I have tried to list them as this here. Top executive accountability and control this is one and top executive remuneration; compensation package for top executives. And then there are mergers and acquisitions which are always somewhat risky related to that and then we will talk about the market the insider trading problem and also the trading agencies. Today probably we will be able to cover up to this first two, but let us see.

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The Board, the Management, and the Shareholders

- Board: Has the vital role to oversee the company's management and strategies for long-term value creation. It selects and recruits the CEO, and delegates the responsibility of managing the business. The Board monitors and assesses CEO's performance, and plans succession.
- Management: With CEO on the lead, has the role and responsibility of managing the company and executing the strategies; including strategic planning, risk management, financial reporting. Management is under the monitoring of the Board, and reports to Board.
- Ordinary Shareholders: Investors, with the goal of getting financial benefits in return. They are not involved in daily management of the company. They expect the Board and the management to be long-term stewards of their interest.

See once more reminding you that we are talking about this the major actors here are like this. We are talking about the management and the shareholders, but there is the board; board of directors which is in between; we have talked about this. The chairman leads the board and I have told you that there can be in the board executive directors and non executive directors.

The chairperson can be either an executive director or non executive director; now for better corporate governance many countries preferred that the chairperson must be a non executive director, just to ensure the impartiality of the chairperson. The management as you I have already explained that their job basically is to manage the company and to execute the strategies and initiatives decided by the board.

But it is in their hand the entire operations lie specifically the risk management, the financial management, the financial reporting and so on, but the board is the overseer; management works under the supervision of the board and reports to the board. Then there are this entire shareholder class; they do not manage the company they are not involved in the daily management, but they expect that the board and the management are going to look after their best interest. So, this is the scenario that we are talking about.

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1. Top Executive accountability and control

- Problem: Though the corporate structure is meant to oversee, monitor and control the top executives, the Board fails to control the top executives from taking excessive financial, business, and reputation risks for short-term profit maximization, or for bonuses for the CEO and the top management team. Result is: Failure of Corporate Governance. Lack of implementation of Corporate Governance Codes and principles.

Issues: 'Greed-is-good' culture, Risky proposals, hasty and risky ventures and expansions, key information suppressed, false or fabricated financial data reported , manipulation of the Board, manipulate share prices, abuse of corporate accounting practices.

Board occupies a key position between shareholders and the company's management. The Board and top management should agree on key decisions; e.g. proper use of capital for both company and shareholders, risk appetite of the company., risk management processes. But top executives may override all cautions.

Duty of Board members: To remain in control of the company, to remain vigilant for detecting lapses, deceptions, and errors, to exercise the shareholders' rights.

The first one is top executive accountability and control you know that the board is going to have the top executives specifically the CEO the CFO's as members. I have also told you that the board job is to monitor the performance of this top executives and board has to work with this top executives. So, then what is this problem here? The problem is that of control; what we are talking about is the situation where the board fails to control the top executives for overriding cautions and reasonable limits of risk taking.

So, what we are talking about is the situation where the top executives want to go for a venture; which seems to be excessively risky either from financial point of view or from reputation point of view; the brand is might be at risk and so on. And it could be that the top executives want to go; go for it for variety of reasons there might be some you know short term goals in mind or there might be you know they are after the bonus they get paid for reaching certain objectives. So, for them the bonus for reaching that objective might be the very alluring. Or it could be that you know the whole culture of corporate greed you know aggression and expansion is that is what it is.

There is adventure in taking up risks and then there are certain mal practices; you know there might be some falsification of data specifically fabricated accounting data and so on we have seen this. So, there would be many reasons why the topics are kept is by one to run away with the decision of the board and the board fails to control them in the board fails to check them in time. That is where we see failure of corporate governance

the board is not doing its duty; the board has failed in its duty to put the right check in right time.

So, we understand now that it is about controlling the topics here is from going out on very risky propositions which may actually jeopardize the company's future and suddenly the shareholders interest. So, the duty here is very clear that board member should act on behalf of the shareholders; that is the prime objective of prime directive for them. And they should look for lapses they should look for deceptions errors in judgment as well as in accounting and so on and they should ensure that the shareholders rights are not violated.

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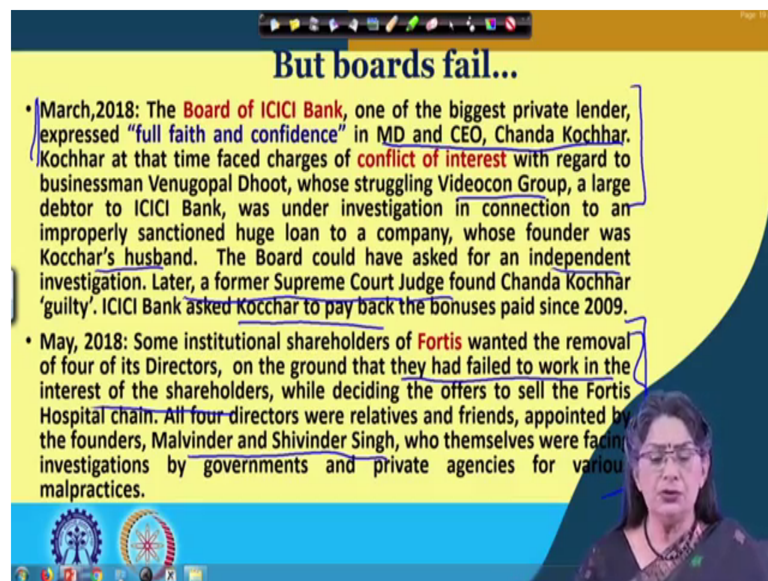

But boards fail; I have given you many examples already, but I will add two more recent ones. See we are talking about 2018, you must have heard about the ICICI bank; its one of the largest private lenders.

They loan out money; people borrow from them and the board seemed to act very weirdly it is about the former MD and CEO of ICICI; Chanda Kochhar, who was already under investigation at that time for the for sanctioning are huge loan to a company, whose founder was her husband. And this company was in was linked to Videocon group which was already a large debtor to ICICI bank. Being MD and CEO; Chanda Kochhar was in the credit committee; the credit sanctioning committee.

She also knew that the company under consideration where the loan is credible sanctioned; it belongs to her husband. So, there was conflict of interests the board knew about this; our board at least saw that these are the charges they could have asked for an independent inquiry into the matter. Instead what they did was to express full faith and confidence in the MD and CEO; later on independent inquiry by a former supreme court judge found Kochchar as guilty. So, there is a big face loss and also a failure of duty by the board of ICICI bank and; obviously, the corporate entity also took some punitive measures to hold Kochhar responsible.

The second case is that of Fortis, where some institutional investors wanted four of the directors from the board of directors four of its directors removed. Because they felt that they the directors had failed to work in the interest of the shareholders, who were they? They were all relatives father in law or friends of the founders namely Malvinder and Shivinder Singh; who themselves were under investigation, under with criminal charges from more than one government you know for various malpractices and financial fraud. So, boards not doing its duty is not uncommon at all; all right.

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The top executives somehow managed to get away with things you might ask, but why would fail what prompts them. I cannot give one answer, but I will try several board behavior is you know human behavior and it is affected by certain things. For example, when we have the situation of the concentrated ownership the controlling shareholder

starts bullying everybody follows the suit and it is very difficult to resist that especially; in a in a board room situation.

Second, it could be that the directors themselves are not very knowledgeable about the company or they are not really competent. So, instead they are in awe of the top executives professional expertise. So, the result is too much trust on the judgment of the corporate executives and therefore, they do not exercise caution which they should have. Third might be that you know managers are trained to be optimistic; you know their projections are for future.

And they carry that optimistic attitude into the boardroom you know presenting a proposal nobody says you know my idea is not going to work. You are going to work for the proposal presenting it as a plausible, feasible and definitely doable thing. So, that and that sometimes misleads or influences the board of directors who fall for it instead of critically evaluating it.

And this we have seen in number of cases where the companies have fallen specifically because board did not raise question; when they should have. Then there is this factor of you know influencing each other there is something called groupthink. When there are people who think alike you know you cannot expect to see all possible answers to assert the questions, you will tend to think in a certain direction.

So, what we are talking about here is that remember the when the board selects the directors; it chooses the members that they it is comfortable with. So, similarity in background, similarity in opinion, similarly in experience and it works for you know unanimity fine. But the risk is that you might miss out on something that could have been pointed out by somebody who is taking coming from a completely different perspective.

So, diversity of views is what sometimes carries out the risk total risk outlook. Then there is this sculptural factor all traditions including Indian system; abhor open disagreement it is considered as discourteous you know in an open board room you in the face who tells somebody that you know you are wrong all cultures do not like that. So, instead of mentioning it in the boardroom typically the board of directors in Indian system; they would come out of the boardroom and sort of whisper to each other hint at some dissent and so on.

And that sometimes causes problem because you know boardroom decisions are taken inside the board not outside the boardroom. Then there is this possibility that the board members might have some collusion, some private gain, some nexus with the topic secateurs. Hence they are not deterring or hence they are not questioning the top executives proposals.

And then there is this also that sometimes the chairman of the board is also the top executive namely the CEO. When that happens in one hand too much power gets concentrated so that you know you present the view from the company's side and you also the one whose are approves it that should not be the case. So, typically people say the separate this out; in fact, there are countries where this is prohibited they always ask for a non executive director to be the chairman of the chairperson of the board.

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There is also the fact; this is also problematic cut that there is a low accountability of board and top executors. When there is a corporate governance failures these are the people who are often not held; not held personally liable for these. So, this is a weak spot which needs some improvement for a; for better corporate governance, there has to be some better accountability of the top people and we will talk about that.

So, how do you address this issue? Now when I say you will hear me coming from the ethical side and you will also find me talking about what the law in our country for example say because and then do not think that you know this means that we are

forgetting or obliterating the distinction between law and ethics. All I am trying to place here is this is where you will see a lot of considerable overlap of ethical concerns and legal concerns. So, both are saying this is wrong and this is how it should be counted.

So, first of all that the counter measure is that the board needs to do its duty; There is no one way to say this that you know if it needs time commitment; then board member should be ready waited. If it requires you to do the homework before coming for the board meeting then that is what it should be done, but one needs to understand that this is a duty and responsibility which you requires some commitment and that they should be ready to accept.

But when said having said that we will have to say that even among the board there is a big emphasis on the role that these NEDs play. So, we are talking about people from outside directors who are from outside the company, but also who are independent; independent let us try to understand this. So, NEDs are competent outsiders; who are not part of the executive corporate executive team, not even nominated by any of the organizations; at least this is what our Companies Act 2018, section 149 says.

What is required foremost is that they should be independent; independent in what sense? No pecuniary interest, no financial interest either they or their relatives must have with the company; that they are (Refer Time: 18:16); this is to ensure that they put the shareholders interest first and not their own.

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On the 'independent' NEDs

2.1 The NEDs should be "persons of integrity" (MCA, GoI). The supposed value of the introduction of NEDs is since their incentive structure is different from that of the executive directors, they will be in a better position to monitor the management on behalf of the shareholders. They are not subject to the possible high-powered conflicts that the executive directors are subject to.

2.2 Since they should not have personal financial interest in the corporation, their remuneration should not exceed a reasonable compensation for their time and other expenses (sitting fee)

2.3. Their number should be sufficient. Companies Act (2013), Section 149, subsection 4: "To balance various interests", every listed public company must have at least 1/3 of the directors as independent directors. SEBI, Clause 49: NEDs not less than 50%, at least 1/3 independent if Chairman is NED, at least ½ if chairman is Executive. Other countries (USA, Australia, South Africa): >50% NEDs.

So, this is group that is often pointed out to be the most important one; who can check who can check the influence or the power of the topics (Refer Time: 18:37). You will hear that there are certain desirable qualities in entities that we look for that the law also ones and general corporate governance; rules one is that they should be first of all persons of integrity.

The whole idea is that they should be out of this power games that are played with corporate executives. You know competitors trying to hijack the corporate that; that executives or you know in times of takeover people are trying to seduce, attract the executives and. So, on the NEDs are supposed to be above all of that. So, impartiality and not being connected to the company is this is what we are looking for.

Second is that because they do not have any financial interest in the company; their remuneration should also not be highly exceeding. So, basically they should be paid the sitting fee; for attending the committee meetings, for attending the board meetings and so on. So, there is no financial interests here which should keep them going for coming back again and again,

Third point is that their numbers would be should be sufficient because you know our Companies Act, section 149 says that their presence in the board is to balance various interests. So, conflict of interests; they are the one who neutralizes. So, what is the ratio and what is the number? According to Companies Act, every listed public company must have at least one third of the directors as independent directors; independent directors.

So, one third of the total board of directors should be independent directors. If you go back few years then SEBI; the regulatory body of India had the clause 49; we will talk about it in our subsequent lecture. But clause 49 made even clearer mandate for this; that first of all NEDs should not be less than 50 percent in the total board composition.

And at least one three of them would be independent if the chairman is NED on the other hand if the chairman is an executive director; then to hold to control the chairman half of the half of the board should be independent directors ok; so this is. In other countries for example, in United States, Australia, South Africa the major rule is you know in the board should have more than 50 percent should be NEDs. This is what is sometimes 60 percent, 70 percent of them are NEDs.

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On the 'independent' NEDs

2.4. Neds should be appointed for a limited time: Companies Act (2013), Section 149,: Maximum term upto consecutive 5 years, but can be reappointed by passing a special resolution in Board, and reported to the shareholders. Maximum two consecutive terms. Can be reappointed after 3 years gap.

2.5. They should be competent, with relevant expertise and experience.

MCA GoI, June 2019: Considering a proposal to require the independent directors to clear an online test on corporate literacy prior to their appointment in a Board : A test on basic Indian Company Law, ethics, capital market rules , etc. Aim is to sensitize the independent directors of their roles, duties and responsibilities. Aim is also to make them more accountable, so that they cannot hide behind the excuse of ignorance over a lapse in oversight.

Further appointment of NEDs should be not be a regular one. So, there is a certain limited time that they can serve; namely maximum term is up to 5 years and there can be consecutively only two terms. If they are to be reappointed then there has to be 3 years gap ok; this is how they see, so there should be rotated.

And then finally, they should be competent and informed they need to understand what their; they are giving judgment about the company, law and other things. So, very recently in June 2019, in fact; as I am when I am recording these lectures; there has been a proposal from ministry of corporate affairs that the independent directors from now on may have to clear an online test.

It is basically a corporate literacy test; before their appointment to any board, they have to clear that they have been working knowledge of company law of ethics, of capital market rules and etcetera. The idea is to in of course, empower them with knowledge, but also the idea is that is they should not be now able to hide behind the excuse that we did not know. So, this is a proposal that we are going to look out for in the future hopes it works out.

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As for increased accountability there are some suggestions stricter liability. You know in order to make the board and the topics get us more accountable for the company's performance; it has been proposed that maybe when they join they can sign a binding code of conduct; which binds them to follow certain standards behavioral standards while serving in the company.

If found to flout to violate the standards there would be some penalty from their gross compensation package, this is a suggestion. So, it is linked to their own behavior as during their tenure in the company. Second the accountability also can be brought in it is there in fact, that if the shareholders are going to appoint the directors and remove the directors; this is already the case. But this is there is a big point about that this is a moral legal right both of those shareholders which is protected by the company law.

And our Ministry of Corporate affairs think that in the appointment and removal of directors for nongovernmental organizations; government should not intervene it is the law it is the choice of the shareholders that should prevail. So, this is removal of directors we are talking about if you do not approve of their decisions then shareholders can exercise that right.

Now in, but there is a procedure you know there is a procedure and where you can do, when can you do and how you can do. But when you have one tier board this is easier, but in two tier situations only the supervisory board can remove members of the lower

board or the management board. The other suggestion is for accountability that we can introduce annual performance appraisal of the directors. The board of directors can we also assessed for their contribution or for their general performance as board members.

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The other problem and the last problem for today is top executive remuneration. We are talking about disproportionate salary paid to the top executives; it happens very often, but disproportionately higher salary. Disproportionate to what; and I am going to give you two answers at these two answers on that first is disproportionate to the performance of the company.

The company is going in the red, but the chief executive is being paid an enormous amount of compensation ok; there is this disparity. So, disproportionate to the performance of the company and that is extremely unfair that when company is not doing well due to the; due to the planning due to the lack of planning or due to whatever activity the chief executive has done the total benefit for CEO remains intact but the loss is entirely transferred to the company and to its shareholders. And that is where we can say distributive justice principle has been severely violated its very unfair.

For example, Porsche CEO got huge 77 million pounds as remuneration in 2008; when the company was going through a serious crisis and that is not really something; does not sit very well with the shareholders. As you can see in the Citigroup example, that they

objected to this excessive pay to the chief executive; when the company was not really doing very well.

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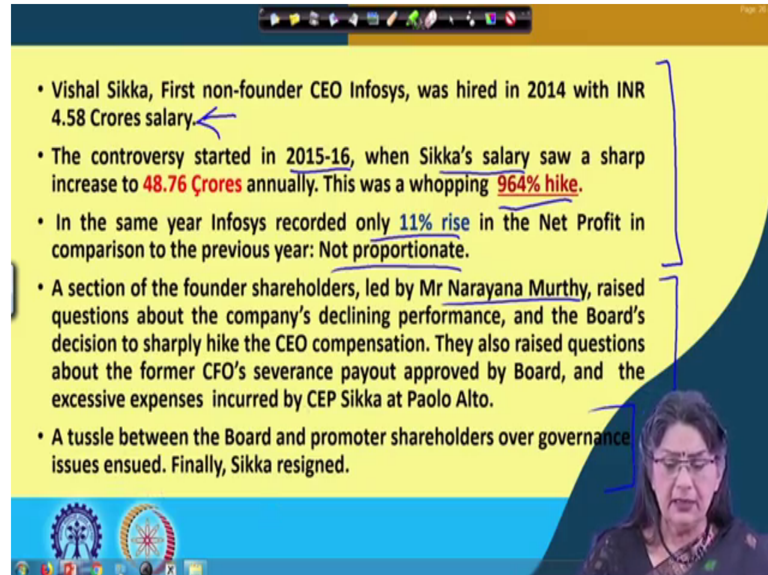

Let me remind you about a more recent case some of you may recall; a couple of years ago Infosys board and some of the founder shareholders got into a tussle. Over the compensation package of the CEO and the severance pay out to the CFO; both were decided by the board of emphasis.

And it is like this; I am going to make it very short that originally Vishal Sikka; who was that non founder first non founder CEO was hired with a salary that was at par with many of the it companies. But the problem started in 2015-16, when suddenly Sikka's salary saw very sharp increase; it was a 964 percent hike. What was Infosys's performance? People said it was only 11 percent better than previous year. So, the idea is not proportionate and in fact, a section of the founder shareholders led by Mister Narayana Murthy seriously objected about that; that this is disproportionate and also how could the board pass this.

So, there was a major altercation and very open debate on this and finally, Sikka resigned of course.

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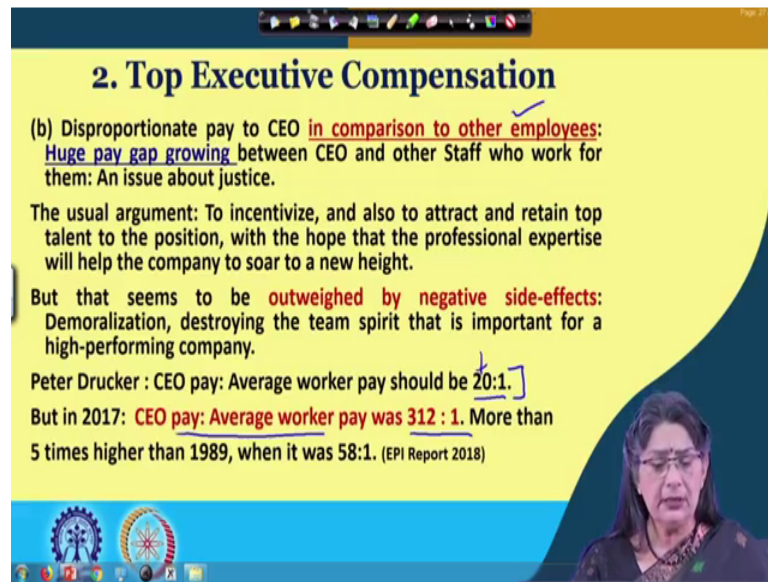

So, disproportionate to the firms performance, but there is another kind of disproportionateness here in comparisons to the other employees. The it is true that top executive and the bottom most employee; their salaries cannot be the same, but nobody is saying that they should be paid equal.

The point here is that even if there is disparity; it should stay within a justifiable limit beyond that it becomes ethically unacceptable. So, what we are talking about here is that if you talk to Peter Drucker; the management educationist, the average worker and CEO pay ratio should be something like 20 is to 1; CEO gets this.

But in 2017; the economic policy institute report says the CEO pay an average worker pay ratio or something like 312 is to 1; 5 times higher than what it was in 1989 and the chasm just keeps on growing.

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So, this is about the pay inequity particularly when you take a look at the GDP; per capita GDP of a certain country; then the pay inequity even becomes more prominent. And this is the case with India this was the case at least in this cases that the global CEO index showed the highest paid CEOs are in the high GDP countries per capita GDP is quite high in United States Switzerland, Netherlands and so on.

But when it comes to comparing it with a per capita GDP adjusted for purchase power; then the order showed that India occupies second highest position in terms of CEO compensation package. The median salary he was found to be 243 times higher than the salary of the average worker. You know this is one example the El Larsen and Toubro; CEO to comb something like 78.91 crores. 1102 times higher than the median remuneration of employees in Larsen and Toubro.

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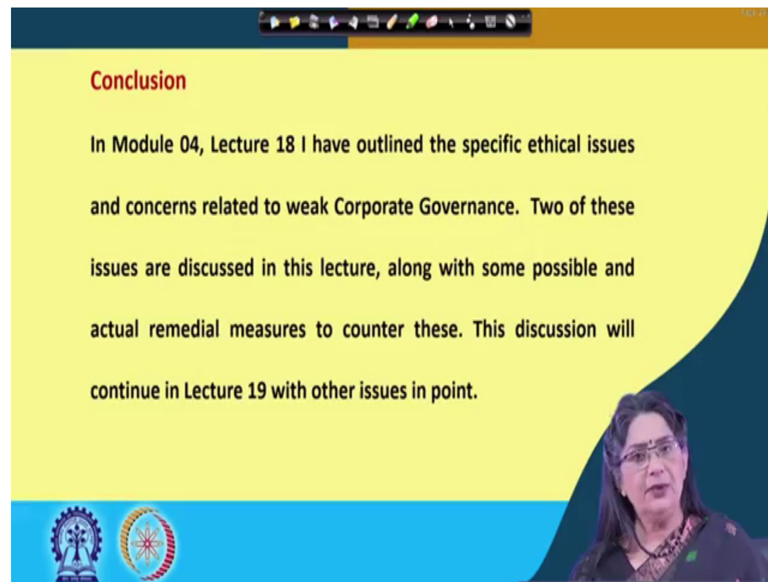

So, this is where the pay inequity comes very prominently and it seems like it does not see it very well with; with anybody especially with the morale of the corporate entity. I am going to stop here, but we are going to continue with this topic; making our next lecture and few many more issues also is going to come up. So, this is where I am going to draw the line today and say.

Thank you to you and goodbye for the time being.