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I don’t see institutional investors being active enough: M. Damodaran

Former Sebi chairman says regulations are work in progress, adding that an overly prescriptive arrangement for corporate governance may be counterproductive

Last Published: Fri, Nov 28 2014. 01 20 AM IST

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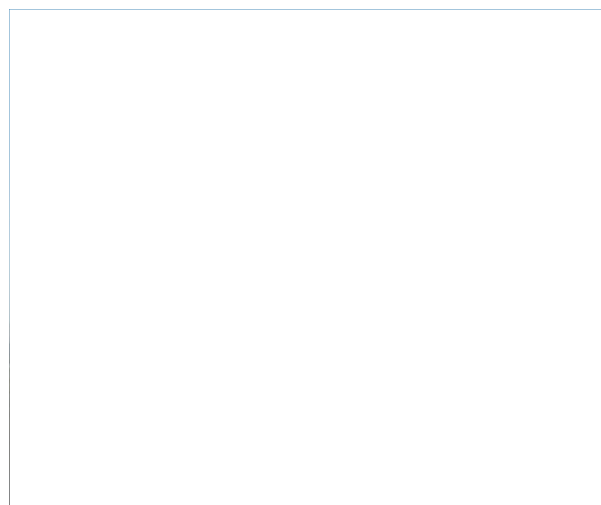
Damodaran says that after about seven-eight years, most independent directors, with a few exceptions, will have their sharpness blunted. Photo: The India Today Group

Mumbai: The new Companies Act and changes made by the Securities and Exchange Board of India (Sebi) to Clause 49 of the listing agreement have tightened the corporate governance norms that Indian firms must adhere to. Whether those norms will make a material change in governance practices across the corporate landscape remains debatable. **M. Damodaran**, founder and chairman of Excellence Enablers and former chairman of Sebi, says regulations are work in progress, adding that an overly prescriptive arrangement for corporate governance may be counterproductive. Damodaran, who currently advises on areas of corporate governance and board effectiveness, says audit committees have been given too much responsibility and that institutional shareholders must make their voice heard. He also calls for stronger governance practices in state-owned firms. Edited excerpts:

The rules around corporate governance have been strengthened via the Companies Act and Clause 49 of the listing agreement. Are the regulations strong enough?

You have to first go back to the Narayana Murthy report and the **Kumar Mangalam Birla** report. Both these, especially the Narayana Murthy recommendations on the basis of which Clause 49 was devised, incorporates most of what was there in the Sarbanes-Oxley Act. Except that some of the provisions that were mandatory there were optional here such as the whistleblower protection. That has now become mandatory, but in the first flush, it wasn’t. The problem with that is that our shareholding pattern is different from the US shareholding pattern. Yet we have lifted a US governance structure and put that on our corporates. Now if you take the institution of the independent director—when it’s a widely held company with no major shareholder or where it’s a management driven company, then the institution of the independent director makes some sense. Because they are the voice of the shareholder. When you have a shareholder who holds more than 50%, whether the government or a private person, the institution of the independent director and what they can do is limited.



The Companies Act has broadly incorporated what was put out by Sebi, but, for the first time, given it a statutory framework. If you read both together, one of the problems is the inconsistencies the two had. Some of it has got ironed out. But you still have an overly prescriptive arrangement. I'm not saying that you should just write general principles and leave it at that. But if you start prescribing far too much detail in the law, then you have at least two problems—one you aren't allowing companies the flexibility that companies need. By flexibility I don't mean flouting rules. More importantly, given our experience in legislation, if you want to make one small change in that, you have to go to Parliament and the entire procedure takes too long.

Independent director tenures have been restricted to 10 years and the number of boards such directors can serve on has been restricted. Is that a step in the right direction?

In terms of restricting the number of boards, it's a step in the right direction. Is seven the ideal number? My own view is that moving from 15 to anything less than seven would have been disruptive. Suddenly, a whole lot of directors would have gone. Seven is a good parking place for the moment, but after about three-four years, I would like to see it move to five. The reason being that most board members have committee work. So if you are on an audit committee, it's a day job. You can't do anything else. If you are on seven reasonably large boards, and if those boards have not just the four mandatory meetings and you have to attend committee meetings, then you really can't do more than five. But I think seven is a good number for now.

As far as term is concerned, I think it's good to have two terms. You don't want to be disruptive and send everyone home after a short term. Independent directors are not experts. They will take some time to understand the domain. You don't need domain expertise, but even to get domain familiarity, you need some time. Now, by the time they get there, if they are already completing their term, then you are getting nowhere. So two terms is good. The problem is that under the Companies Act and under the new Sebi

rules, all of this starts now. You look at people who have been on boards for 20-plus years already, and if the meter starts ticking now, you are talking about another 10 years. After about seven-eight years, most people, with a few exceptions, will have their sharpness blunted. After some time, you are at least behaviourally an insider. You won't ask the tough questions. You'll become one of the crowd. I would have liked both the Companies Act and Sebi to say that if you have already been a director for more than five years, you will only get one more term of five years. That is what Sebi had said in the first draft of its new rules, but now because of the alignment with the Companies Act, it went to two terms. And I don't buy this argument that there aren't enough independent directors. If you look around, you'll find them. If you look only within your circle of friends, relatives and former classmates, then yes, the number may be limited. We can look at universities and academic institutions, we can look at officials from companies in a different product area or functional area. Why don't we have environmentalists on our boards? So, number is not an issue. I think giving two terms starting now leaves it too late to bring freshness. In all of this, what you need is continuity with change. You are ensuring continuity with continuity. Change is 10 years away.

A lot of onus has been put on the audit committee as part of the new rules. Do you think audit committees and people who serve on these committees will be able to fulfil that role?

The audit committee's role has been significantly enhanced. There is no doubt about that. In terms of composition, except for the person who chairs the committee, there is no requirement in law or regulation that the person should have any understanding of finance. Accounting standards are many. Regulatory prescriptions which have an impact on accounts are many. If you don't have a nodding acquaintance with finance or with law, you are not cut out to serve on the audit committee as a serious member. Most boards don't have too many people with those skills. Plus, the person must be willing to give the time. Take related-party transactions. Today, in some ways, the audit committee takes the final call on whether the pricing is arm's length. But arm's length is not defined. You are using the income tax definition. I'm not saying that you should stuff the audit committee with chartered accountants. That could also be disastrous. But you need to have a far more detailed induction programme for members of the audit committee and that's not happening. You also need frontline leadership in the audit committee so that you are able to get the best out of the people.

The flip side of giving all this responsibility to the audit committee is that in most boards, you will hear some member or the other saying—has the audit committee seen it? Beyond that, many boards will not even bother to see it. So overloading the audit committee in some sense gives far too much comfort to the rest of the board which tends to rely excessively on the committee. So I would think the audit committee’s role should be not as much as it is today.

There is a lot of push back on the rules that say related-party transactions must get majority approval from minority shareholders. Are those norms making it tough to do day-to-day business? Also, doesn’t the success of that rule depend on the willingness of institutional shareholders to take a stand?

If you look at the non-institutional minority shareholders, the retail investors, this is the only way through which you can ensure that the majority shareholder does not benefit disproportionately. If these restrictions did not exist, what a majority shareholder would do is create a subsidiary with a different shareholding pattern and do transactions that benefit the subsidiary at the expense of the main company, if that’s where my money lies. The only way to bring that under control is to ensure that the majority vote of the minority shareholders decides on such related-party transactions. There is a lot of criticism of this proposal. But what is the essence of the proposal—it is a transaction that you are having with an entity where you stand to benefit because the shareholding pattern is different. If it’s a wholly owned subsidiary which mirrors the shareholding pattern, there is no problem in that. But the issue really is that you can’t keep going to shareholders on a continuous basis. So what most people have done is that based on past transactions, you figure out whether these are transactions that can be considered to be in the normal course of business. Then on the issue of arm’s length, you look at the pricing of competitors to see if it’s within a reasonable band. Ultimately, it’s a question of how long will you continue to do business only with related parties. There is an extreme view that over time you must reduce related-party transactions. But so long as related

parties exist and they give you the best deal and it doesn't militate against the interest of shareholders, where is the harm? So here again, the audit committee's role is critical. Over time, again, my belief is that you will have to see one or two of these transactions going to the shareholders and being rejected. If that happens, then everybody will start thinking about such transactions carefully.

As for institutional shareholders, I think, in India, institutional shareholders went to sleep long ago and they haven't woken up. I don't see institutional investors being active enough in AGMs (annual general meetings) or in boardrooms. If it's a lender who comes in to the boardroom, he is only looking at whether his instalment is being paid in time rather than looking at how the company is doing. So institutional investors must see themselves as representatives of shareholders.

What about governance practices at government companies? Coal India Ltd doesn't have a single independent director, for instance. And enough questions have been raised about governance at state-owned banks...

Coal India doesn't have a chairman. We talked about institutional shareholders. Where are the institutional shareholders? Why aren't they making a noise? And the chairman in these companies is not a decorative post. He or she is the operational head. I wish someone would go to court and say that the majority shareholder who is controlling all this is failing in his duty and destroying shareholder value because my investee company is suffering from lack of leadership. These are areas where institutional shareholders need to become active. If you look at the public sector, without much ado, they asked a lot of independent directors on public sector boards to go. Are you saying that because they were appointed by a previous political regime, they were non-independent? Are you saying their replacement will come from different stock? Importantly, do they (independent directors) express any opinions in boardrooms. I've asked oil marketing companies this many years ago. Government tells you that we can't raise prices and you are finding that the company is bleeding because they can't raise prices. You are independent directors—your duty is to the company. It's not to the government that appointed you. Have you protested? I was told by some that we did protest. My next question was—did you get that protest documented? Then you get this dubious argument of the fact that the larger public interest has to be served. But you are not sitting on that board to serve larger public interest. That's the point I'm making—when you get to the boardroom and the door closes behind you, your entire universe should be that company. Then, take the manner in which these independent directors are appointed. Who appoints them? The minister does along with the procedural appointment requirements.

So the owner must realize that ownership and management are different, and you must bring in people for the right reasons.

There is also the issue of enforcement of the regulations, which is not easy...

I wouldn't say it's not easy but it's time consuming. Firstly, all legislative and regulatory processes take much longer in India than they take elsewhere. Courts take their own time, regulatory authorities take their own time. The second is that given the situation in which regulatory authorities work, any decision that you take or don't take, can be second guessed and motives attributed. So you tend to go chronologically, in which case the small cases may get taken up first while the big cases may be pending. Then we have a problem of the degree of proof especially when it goes in appeal. In securities law, given that a lot of public interest is involved and the proof is difficult to come by sometimes, you must go by the test of preponderance of probability. You look at all the facts and see where probability leads you to. If you extend the criminal law doctrine of proving beyond doubt, between these two stools, a lot of doctrines will fall.

Then if you look at Sebi's history, initially the appeal against Sebi's orders was with the high courts. High courts take their time and then you go to the Supreme Court. Now high courts deal with it because you have a high court judge who heads the appellate tribunal. But then even if the judge has an understanding of how securities law works, the other two members may not be familiar. So again, is it rightly constituted? I'm not sure. Then some of them do two years as members and go on.

So, given the totality of all of this, the regulatory process grinds very slowly because if you start investigating something, you don't drop it. Why don't you drop it? Because someone may ask why did you drop it? So it's safe to keep it pending. The question is why allow the entire pipeline to get clogged with cases like this. That's why we introduced the consent scheme. It was intended to take out all these small cases so that your core investigative work and regulatory work focuses on the systemically important matters and not on small insignificant matters. But the consent scheme went to grief because a number of important cases also started to go under that. Then it got tied up in knots and now again I'm told they are trying to see how to make sure it works the right way. The test is very simple—take the cases below a certain cutoff, ask the question is it systemically important? Is this a case through which I can send a signal to the system? And that is where enforcement is critical. You can't catch everyone that makes a mistake. Take big cases, bring them to a conclusion quickly and have a punishment that acts as a disincentive. Then you don't have to deal with the body of small cases. You can write any number of regulations, you may also seek to enforce them but unless it is fast and picks on the systemically important cases and comes down hard on them when there is proof, regulation will always be work in progress.

First Published: Fri, Nov 28 2014. 01 20 AM IST