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Exemplary punishment, not more rules, will improve corporate governance: M Damodaran

You cannot go after 100 percent of the offenders, but you can hand out severe punishments so that people think ten times before they try to game the system, Damodaran said

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A flurry of auditor resignations in the last few months and the silence of some top boards on conflict of interest is worrying investors about corporate India's governance standards.

Till recently, the popular view was that India was better than most other emerging markets on rules and processes followed by the boards of listed

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The recent chain of events have many investors wondering if the recent chain of events indicates an even deeper malaise within corporate boards.

But former chairman of the Securities and Exchange Board of India, M Damodaran feels the situation may not be as bad as it is being made out to be. “More skeletons are tumbling out of the closets now. That is an indication that more questions are being asked now and there is better recognition of the problems now,” Damodaran told Moneycontrol in a free-wheeling chat.

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Damodaran feels that more regulations is not the answer to inaction or violations by company boards. “The answer to corporate governance lapses is not more regulations.

We already have enough rules,” said Damodaran, who now plays varying roles of governance consultant, advisor, mentor and coach. He is chairperson at Excellence Enablers, a governance consultancy firm founded by him.

Damodaran said if companies had too many rules to comply with, they would be distracted from the core activity of running the business and delivering value to shareholders

“Also, compliance has a cost. Eventually, that cost is borne by the shareholder. And this is not the case only in India. It is a global problem,” he said.

He cited Sarbanes Oxley Act of 2002 in the US, which had many small businesses complaining about the cost of complying with the rules and saying they wanted to delist from the stock exchanges.



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and exemplary punishment. What SEBI needs to do is hire more lawyers and accountants so that it becomes easier and faster to deal with issues,” Damodaran said.

He said regulators need to do a Regulatory Impact Assessment (RIA) whenever regulations are written. They should check whether the rules are cost effective, and whether they serve the purpose they were meant to. “Unfortunately, that is not happening today,” he said.

According to Damodaran, two major areas where governance standards need to be tightened are Related Party Transactions (RPTs) and insider trading. In both areas, there was good progress, he said.

“Audit Committees are asking companies increasingly tough questions on vendors and distributors. If a company is sourcing materials from just one or two vendors, they need to justify it.

The company’s defence that they do so to ensure quality may not be enough. They have to provide the benchmarks for quality. That said the elimination of wrong practices associated with RPTs is still work in progress,” he said.

More powers for SEBI?

Recently, the committee on fair market conduct recommended that SEBI seek direct power to intercept calls to strengthen their case against market manipulators. The Central Board of Direct Taxes has this power.

Damodaran feels SEBI can do without such a power.

“The problem with SEBI is not of inadequate powers. It is among the few regulators which has legislative, executive and judicial powers.



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them, he said.

“A better way to send out a strong message is to take up a few big cases and hit the offenders hard,” he said.

Damodaran said that in the US too, it was rarely the SEC (Securities Exchange Commission) which intercepted calls and went after the big fish; it was the Attorney General’s office.

He said the two things that regulations must try to fix are conflict of interest and asymmetry of information. “Whenever you see issues of conflict of interest, such as in related party transactions, you need to have zero tolerance and stamp them out immediately,” he said.

Insider trading curbs

But fixing asymmetry of information was far tougher, he said. “In the matter of asymmetry of information, zero is an aspirational level. You will never really be able to eliminate it.

That is because some people will always have more information and faster information than others just because of the position they are in. That should not translate to use of information for personal enrichment,” he said.

Damodaran said some of the recommendations in the draft note, such as designated persons having to disclose shares held by parents, spouse, siblings and children, would make it even more difficult for someone to avoid regulatory glare by trading in a relative’s or an associate’s name.

“There will be never a perfect level playing field. Regulations should be such as to create a level playing field to the extent possible. The rules should promote confidence among investors and intermediaries so that the smaller players don’t



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he said.

Independence of directors

Another major issue affect corporate governance was the true independence of independent directors on the board. While companies meet the requirement of having independent directors, more often than not, it is a charade because those directors usually back the management decisions without asking any tough questions.

“You will rarely have truly independent directors. The two main criteria for independent directors is that they should not be familial relationship or commercial relationship with the company and its promoters or management,” Damodaran said.

“However, satisfying these two conditions does not necessarily mean that a director will be independent in the true sense of the word. Some directors try to be seen as being independent even though they are not. There are only few who do not need any incentive to fulfil their responsibilities in the true spirit of the law,” he said.

And yet not all was lost because the rules now for independent directors are far stricter than they were before.

Saving PSU banks

“You have more liabilities, bigger penalties... so the sole intention of self-preservation itself should force many of these independent directors to behave responsibly,” Damodaran said.

Damodaran felt public sector banks are not beyond repair. According to him, there are four key reasons why things have come to such a pass.



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free from interference or influence. Third, the government left top positions in many banks vacant for a long time. That hurts the decision making process because the interim head will have no incentive to give his best because he knows he will not get the top job. Fourth, the government has not been able to differentiate between ownership and management,” he said.

Damodaran said the government does not have to call the CEOs (of state-owned banks) to Delhi every two months for an update. “It has a nominee director on the board of every (state-owned) bank who should be the bridge between the owner and the management,” he said.

Damodaran’s suggestions for fixing the mess at PSU banks:

“Have a good hiring system in place. You can’t have a prospective bank head be interviewed by ex-officio persons, some of whom have no idea how the banking sector works.

Hire a good CEO and give him enough time in the role to be able to do a good job. Compensation may not be a deal breaker. There are enough good people who are willing to take on the responsibility even if the money is much less than what his counterpart at a private sector bank is getting.

Pack the board with credible people, and delink ownership from management. Empower the board and hold it accountable for performance.”

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