PUNE INTERNATIONAL CENTRE

TOWARDS BETTER CORPORATE GOVERNANCE

Completing the Unfinished Agenda

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CONTENTS

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EXECUTIVE SUMMARY

Good corporate governance is not just a 'good thing to have'. It is a 'must' for the functioning of a sound democracy. The disastrous effect of bad governance is accepted widely as the key factor in the recent downfall of the western economies. While a great deal has been done to improve corporate governance in India, much more remains to be done. This paper addresses the unfinished agenda and suggests implementable solutions. Good corporate governance benefits all stakeholders including shareholders, employees, customers, regulators, vendors as well as society. Corporate governance practices in a company are influenced and shaped by the missions and values of an organisation and actions of regulators, dominant shareholders, board members, major customers and social activists.

The formation of SEBI in 1992 heralded a new era for corporate governance in India. Various committees and professional groups have made valuable recommendations. The paper takes cognizance of the efforts made by these groups. While the governance processes in other countries were studied, the proposals are specifically formulated to address the Indian governance issues and are designed to work under Indian conditions. The paper is a culmination of the process, which stared with collection of opinions from intellectual achievers, followed by structured analysis and completed by generation of implementable solutions. One of the key contributions of the paper is the Corporate Governance Index (CGI). This easy to use self-assessment tool is suitable for all companies and will make the journey towards good corporate governance an easier ride.

The proposals in the paper do not require many additional cumbersome regulations. The recommended actions will benefit most of the stakeholders. The need of the Indian economy to attract capital as well as to retain and enhance its vibrancy is the backdrop for the paper. Proposals that can stifle investment or entrepreneurship have been avoided. The paper provides for an automatic review of all proposals every 5 years and there is a15 year sunset clause that applies to them. These 2 provisions have been introduced to ensure that good regulations and practices will stand the test of time, through a periodic review against the then prevailing realities.

The paper is structured in the 'Overview, Issues-Here and Now, and Proposals' format. Various areas of governance are enumerated. For each area the paper first provides a macro level understanding, followed by highlighting specific issues that exist in India and ends with implementable solutions.

Business policies and practices have significant social consequences. Globalisation of Indian companies and the advent of information age have brought corporate management face to face with increased stakeholder interaction. There is increasing awareness amongst the stakeholders about what is right for them. The two-way relationship between ecosystem and business is now more evident. Successful leaders of the new economy will be the ones who effectively integrate sound relationship with stakeholders into their business practices. Social audit is the tool for these companies to become aware of the state of their stakeholder relationship.

The board is the most important slice in the organisational pyramid of a public limited company. Board members have the crucial role of maintaining the alignment of interests between various stakeholders and company management. Because of high impact corporate scams, national governments are under electoral pressure to enact stricter regulations on companies. An increasing role is being assigned to the board members in the management of corporate governance. In particular, the independent directors are increasingly being tasked the role of providing the checks and balance within the board. Results of polls conducted with board members in India on corporate governance issues have shown interesting results. The board members see weak oversight, management override and poor risk management as key stumbling blocks for improving governance. Nearly 80 % felt that good governance should be practiced through a mix of principle based standards and moderate regulation.

In India as in many Asian countries, there is one more influencing factor. There are many companies, which were originally family owned and where founding family members still wield significant influence and often the final authority. Company boards in India have a major gender imbalance. Only 6 % of the directors of the top 100 BSE listed companies are women. There is a clear need to accelerate the efforts to achieve better gender diversity.

CEO compensation in India has gone up very rapidly over the last 2 decades. It is clear that the gulf between the effective compensation of CEOs and the average employees is widening fast. Employee Stock Option Plan (ESOP) is a compensation innovation that has gone awry because of human greed and ineffective regulatory process. USA has strict regulations about the pricing of options. In contrast, India is one of the very few countries that allow heavy discounting of stock options. A CEO can get stock options by paying only 1 % of the market value of the share. The stock option process needs to be more effectively regulated.

Illegal insider trading is vexing problem for regulators and exchanges all over the world. Many countries have enacted tough laws to curb this menace. United States has some of the strictest, including a bill passed in February this year, which brings the lawmakers in the ambit of Insider trading regulations. Tough deterrents, of a similar nature have not been commonly used in India. In addition, the factors like substantial family holdings and large numbers of stock options held by senior mangers and key employees have complicated the insider trading issues in India.

One of the major causes of the 2008 economic crisis was the breakdown of risk management in the corporate world. Poor compensation policies allowed the 'profit is mine and loss is yours' style of risk taking. High growth economy often fosters high risk taking behavior. Rapid growth tends to mask risk failures and reckless risk taking culture proliferates. Most Indian companies are riding the high tide of economic boom.

The risk assessment process is often being swept aside in this high tide. Information Technology has permeated the operations of most Indian companies. In many cases IT has reached mission critical applications. Rapidly evolving areas like cloud computing and use of social media at work have brought in a totally new set of risk parameters.

Many fraud cases against companies were successful mainly because of the crucial evidence provided by whistleblowers within those companies. India has lagged behind other countries in implementing whistleblower regulations. While the nation is watching the progress of the whistleblower protection bill 2011, the corporate sector can initiate action. Companies that have well run internal whistleblower programmes have found it greatly beneficial for improving employee morale as well as management efficiency.

Transparency is one of the key supporting pillars of good governance. Opacity leads to distrust between stakeholders, corruption and inefficiency within organisations. Central and state governments in India have set up transparency initiatives like e-governance, RTI, social audit of development programmes. The openness within the corporate world is yet to keep pace. Some of them are grappling with the dilemma between the comfort with opacity and the unfamiliarity with transparency. Well-governed companies have already implemented transparency in dealing with the stakeholders. Voluntary disclosures, more frequent and robust shareholder communications, full sharing of information with independent directors, early involvement of suppliers in product design and other such actions are taking root in the Indian corporate culture.

Today, more than at any other time, innovation has become a crucial factor in the success achieved by Indian companies. A crucial test for an effective innovation ecosystem is the way the company translates these innovations into sound and sustainable financial results.

Innovations lead to changes in efficiency, productivity, use of resources, competitive positioning and other aspects of business. Indian companies are full of internal dilemmas and conflicting priorities. Organisations, which have a sharper focus and higher visibility for innovation, have achieved better results.

Each of these facets of corporate governance have been provided with proposals, which when implemented, will improve the corporate governance of the company. These implementable solutions have been worded as mandatory actions, since these are all good to do activities. It is left to the Corporate Governance Advisory Board of the Ministry of

Corporate Affairs, to decide the timeline for having these proposals moved from voluntary to mandatory.

The **Corporate Governance Index (CGI)** is the key recommendation of the paper. As the movement to improve corporate governance took root, a few key questions arose – 'what is the right model, how do we know that we are making progress and how d o we compare with others'. Therefore, while developing the **CGI**, two factors were paramount in our process. First one was to have an appropriate governance model and the second was the ease of the rating process. The **CGI** provides an easy self-evaluation tool for the company board. It enables them to benchmark against the best in class and to become aware of the areas that need improvement. The verifiable statements in the index provide the 'what should be' condition as well as the direction and milestones for making the necessary changes. The paper has suggested a possible phased approach for implementing CGI. Based on the experience during the initial period of voluntary application, the **CGAB** will work out a weighted scale and rating norms. This will be commonly used by all to ensure parity.

The policy paper on corporate governance put together by Pune International Center has only concentrated on the unfinished agenda. It provides the decision makers with the backdrop of macro level visibility of important facets of corporate governance. It then takes them closer to the specific issues that exist in India. This is followed by implementable solutions. The easy to use self-evaluation tool is unique in its simplicity and coverage.

The management of change is always difficult. When it involves deeply entrenched opinions and habits, it is a far bigger challenge. The journey up the corporate governance ladder is one such change. This paper has made some tools available for the stakeholders to manage this change and achieve good corporate governance in India.

PREAMBLE

Good Corporate Governance is not just a 'good thing to have'. It is a 'must' for the functioning of a sound democratic society. The disastrous effect of bad governance is accepted widely as the key factor in the recent downfall of Western economies. While a great deal has been done to improve Corporate Governance in India, much more remains to be done. With the introduction of a landmark Companies Bill 2011, the ministry of Corporate Affairs has put a spotlight on corporate governance. This bill has started a national debate. This paper is brought out by Pune International Center to take this debate further, to enlarge its scope and to take a deeper look at the various facets of corporate governance. The paper addresses the unfinished agenda and suggests implementable solutions. Some of these solutions can be implemented in the short run and others will require a longer time line to make them effective.

Corporate Governance means different things to different people. This paper uses the statement that good Corporate Governance –

Encourages efficient use of resources

Requires accountability for the stewardship of these resources

Ensures balance between economic and societal goals

Leads to sustainable corporate growth

This perspective clears the decks for setting up a governance structure, which enables sustainable corporate growth, while ensuring transparency and accountability to stakeholders in and around an economic organization. Good Corporate Governance benefits all stakeholders including shareholders, employees, customers, regulators, vendors as well as society. Corporate Governance practices in a company are influenced and shaped by the missions and values of an organization and the actions of regulators, dominant shareholders, board members, major customers and social activists.

Even during the early days of development of capitalistic economy, the founder of capitalism, Adam Smith had condemned the abuses of the mega companies of his time. He had warned that these companies can become *"...nuisances in every respect"*, since the monopolies they fostered, inevitably led to profit destroying corruption. Incidentally, one of the companies he was referring to was the East India Company.

The issue of Corporate Governance became more important as more and more companies went public, thereby creating a new class of the minority shareholder, who owned part of the company, but did not have any influence over its day to day running. Realizing the influence large corporations can wield over societal issues, various governments took steps to bring about good Corporate Governance. During the last 20 years, beginning with the Cadbury report of 1992 in the UK, to the recently passed STOCK (Stop Trading On Congressional Knowledge) act in the USA, there have been various steps taken by western governments to regulate Corporate Governance. The economic downturn of 2008 has renewed the global drive for improving Corporate Governance.

Economic growth over the last century has led to a gradual shifting of power to economic leaders. The world's largest company, Walmart has revenues which are more than the GDP of all but 25 countries and its employees outnumber the population of almost 100 nations. The world's largest asset manager, a New York company called Black Rock, controls assets, which are greater than the national reserves of any country on the planet. Private philanthropy, the Bill and Melinda Gates Foundation, spends as much on healthcare, as the World Health Organization does.

As Ed Miliband wrote from Davos in the NY Times on January 26, 2012, *"There is a great difference, however, between being willing to talk about an issue and being ready to act. It is a difference between those who still believe that all governments can do is get out of the way and those who believe there is a real role for governments in first reviving our economies, and then setting the right rules for future success.*

Governments can set better -not necessarily more- rules to encourage productive businesses that invest, invent, train, make and sell real products and services. We need rules that discourage the predatory behavior of those seeking the fast buck through hostile takeovers and asset-stripping, that do not have the interests of the shareholders, the employees or the economy at heart."

David Rothkopf wrote in 'Viewpoint' from the World Economic Forum in Davos in January 2012, *"Corporations have morphed from legal entities designed to ensure that an enterprise could survive the death of its owners, to institutions possessing more rights than people. ...As borderless super citizens, global corporations have changed the international order, and yet our rules and approaches to governance remain the same."*

The Indian brand of 'Democratic Development Capitalism', as David Rothkopf has named it, calls for an effective balance between regulatory and developmental objectives. The proposals in this paper therefore, do not recommend the setting up of more cumbersome regulations, but actions, which will benefit most of the stakeholders. The need of the Indian economy to attract capital and to retain and enhance its vibrancy has been the backdrop for this paper. It is essential that the international investing community see our Corporate Governance practices as being superior to other economies. This paper has avoided proposals, which stifle investment and entrepreneurship. Good Corporate Governance is more effective, when achieved through a judicious combination of statutory regulations, self-initiation and self-evaluation of progress. In keeping with the current trend, a greater role is planned for the independent directors in ensuring sustainable corporate growth. It is felt that the government should show the way towards good corporate governance, by establishing these proposed good practices in the public sector corporations at the earliest. As the dominant shareholder in these companies, the government can lead the other publically held companies and eventually other organisations like the section 25 companies, NGOs, Foundations to follow this path towards good corporate governance. It is expected that MCA will have discussions with some of the stakeholders in connection with the proposed Companies Bill. The improvement of corporate governance, in a complex corporate ecosystem like India, will require ongoing dialogue and review of the issues and implementation of proposed actions. The proposed Corporate Governance Advisory Board **(CGAB)** will provide a high value ongoing channel for transparent interaction on corporate governance between MCA and all the other stakeholders.

This paper has two important provisions, which apply to all the proposals. It provides for an automatic review of the proposals every 5 years. There is a 15-year sunset clause covering all proposals. These two provisions have been introduced to ensure that good regulations and practices will stand the test of time, through a periodic review against the then prevalent realities. Secondly, the automatic sunset clause forces all stakeholders to take a thorough look at the results achieved by implementing these proposals and to retain only those, which have withstood this rigorous test.

The wording of the proposals is mandatory in nature, since these are all 'good to take' actions. However it is left to the proposed Corporate Governance Advisory Board (CGAB) to set the time line in consultation with all stakeholders. This process takes care of manageable introduction of each implementable proposal to apply it selectively to different parts of the corporate world.

The formation of SEBI in 1992 heralded a new era for Corporate Governance in India. The recommendations of committees chaired by Mr. Kumar Mangalam Birla in 2000 and by Mr. Narayana Murthy in 2003, made a significant impact on the Corporate Governance scene in India. Those provisions as well as proposals made by apex industry associations, professional organizations, leading audit / consulting groups, rating agencies, and enlightened corporate groups have been studied along with the best governance practices in the management of corporate boards. The proposals in the Company Bill 2011 have been looked at. The paper takes into cognisance the efforts made to date by these different groups. While the governance processes in other countries were studied extensively, the proposals are specifically formulated to address the governance ecosystem in India and are designed to work under Indian conditions. While preparing the paper, ideas were generated from a broad cross section of societal leaders, through a round table and one-on-one discussion meetings. The paper is a culmination of the process, which started with collection of opinions from intellectual achievers, followed by structured analysis and completed by generation of implementable solutions.

Besides the Board and shareholder related issues, the paper also dwells on important areas like insider trading, innovation, transparency and balancing of societal and corporate goals. Good corporate governance is needed for all economic organizations as well as for media, healthcare, education and NGO sectors. However, at this stage, the proposals in the paper are tailored more for the organized corporate sector, covering both public sector corporations and other private sector public limited companies. In fact it would be very helpful if the public sector corporations are at the forefront in implementing these proposals. The remaining sectors like merchant bankers, rating agencies, media, healthcare, educational institutions and NGOs will be covered in the next phase.

One of the key contributions of the paper is the Corporate Governance Index **(CGI)**. This easy to use self-assessment tool is suitable for all companies and will make the journey towards good corporate governance an easier ride.

STRUCTURE OF THE PAPER

The paper is structured in the 'Overview, Emerging Issues, and Proposals' format. Various facets of corporate governance have been covered. These include The Board, Employee Stock Option Plans, Risk Management, Insider Trading, Information Transparency, Innovation Ecosystem, Whistle-blower Process and Social Audit. For each facet the paper provides a macro level understanding of related areas. This is followed by highlighting specific localised issues and then ends with implementable proposals. These include both short and long term proposals. The approach taken in the paper will enable decision makers to have the benefit of a broader perspective and also provides them with implementable solutions. Care has been taken to include only such proposals, which will neither add any major hurdles in the creation of capital for the innovative entrepreneurs, nor will it adversely affect liquidity in the market. The Corporate Governance Index provides a simple self-evaluation tool for company board members to improve the governance standards. A case study is provided as an example of how the CGI can be applied to real companies. In the end the executive summary, covers some key aspects of each of the facets and the CGI.

GENERAL PROPOSALS

The **M**inistry of **C**orporate **A**ffairs **(MCA)** to create an institutional mechanism to promote good corporate governance. Towards this is proposed that the MCA create a **C**orporate **G**overnance **A**dvisory **B**oard **(CGAB)** The board will periodically review all matters relating to corporate governance issues and provide guidelines to the government. **CGAB** will also act as a channel for ongoing dialogue on corporate governance between **MCA** and all other stakeholders.

All changes proposed in this paper shall be automatically reviewed after every 5 years and shall have a built in sunset provision at the end of 15 years, unless specifically renewed.

THE BOARD

Overview

The Board is the most important slice in the organizational pyramid of a public limited company. Board members have the crucial role of maintaining the alignment of interests between various stakeholders and company management. This alignment is the keystone of the long-term sustained growth of a public limited company. The importance of board is reflected in the IR global Rankings system, where board structure and board accountability form the two key parameters used to generate these internationally recognized Corporate Governance rankings. Different economies operate with varying patterns of board structure. The power sharing between the management and the Board varies and various governments have often regulated it in different ways.

As Nobel Prize winner Josheph Stiglitz puts it, *"We may increasingly be a part of a global economy, but almost all of us live in local communities and continue to think, to an extraordinary degree, locally."* There is unstoppable globalization of the economic universe and intense localization of the political world. These divergent forces are very much in evidence in the delayed settlement of the Euro zone financial crisis.

Research findings of Dr. Franklin Allen of Wharton Business School indicates that different national corporate governance models may have influenced the way different countries emerged from the economic crisis. There is a need to identify a sustainable and effective corporate governance model. What is needed is a hybrid approach that makes the best use of the best concepts pulled form a number of models. There has to be a different way to look at the value of the firm. Should they look at shareholder value or stakeholder value?

Because of high impact corporate scams, national governments are under electoral pressure to enact stricter regulations on companies. The global corporations are understandably reluctant to operate with a diverse set of rules in different geographies. These opposing forces are putting pressure on political leaders, as they look for common international ground within the vast array of different national governance regulations and try to align these closely with the pressures of their own political systems. There is one common trend within this diversity. There is an increasing role being assigned to board members in the management of corporate governance. The proposals in this paper are based on this common trend.

The governance failures in major corporations around the world have brought the Boards of these entities in an unfavorable spotlight. In their book 'Money for Nothing' John Gillespie and David Zweig have written, "...Boards have come a long way in the nearly 40 years since Harvard Business School professor Myles Mace dismissed them as 'Nothing more or less than the ornaments on the corporate

Christmas tree. Unfortunately several boards haven't come far enough to make a real difference in guarding and growing our investments – and far too many remain negligent and ineffective.

...Boards are elected to monitor, to advise and direct managers hired to run the company. They have a fiduciary duty to protect the interest of the shareholders. Yet too often, boards have become enabling lapdogs rather than trustworthy watchdogs and guides.

After the bursting of the internet bubble and the corporate governance debacles in companies and other institutions, there was a lot of soul searching and debate about the role, responsibility and accountability of directors. John Stout wrote in Star Tribune on September 29, 2002, enumerating Twelve lessons for the corporate directors are-

1. Integrity is everything
2. Boards must take more responsibility for compensation, perks and incentives
3. Carefully assess actual and perceived conflicts of interest
4. Pay close attention to directors' duties: care, loyalty, compliance and oversight
5. Strive to understand risks
6. Pay attention to warnings
7. Confront problems promptly and forthrightly
8. Transparency is good
9. Targets are good; quarterly earnings obsessions are bad
10. Monitor corporate disclosures
11. Reputations take years to build; moments to loose
12. Good governance in actuality, not just in appearance

Many of these lessons are timeless and so obvious and yet, as John Gillespie and David Zweig put it, *"...Ideally a board of directors is informed, active and advisory and maintains an open but challenging relationship with the company's CEO. In reality, this rarely happens. In most cases board members are beholden to the CEOs for their very presence on the board, for their re-nominations, their compensation, their perquisites, their committee assignments, their agendas and virtually all their information. Even well intentioned directors find themselves hopelessly compromised, badly conflicted and essentially powerless..."*

Similar situations in different parts of the world have driven governments to increase the involvement of board members through regulations and to use the independent directors to set up the check and balance process within the board. In India, as in many Asian countries, there is one more influencing factor. There are many public companies, which were originally family owned and where founding family members still wield significant influence and often the final authority. A number of these companies are making generational transition in their leadership. As Prof Joseph Fan of The Chinese University of Hong Kong puts it, *"We need to recognize the unique nature of these companies and their national and cultural contexts, and look at how to modify the western governance models to fit them."*

Apart from the family dominated companies, the 'One Man Show' problem has significant impact on board governance. Companies like Worldcom, Tyco, Adelphia Healthsouth, Newscorp; belonged to widely divergent sectors, but they shared one common trait. As Geoff Colvin wrote in Fortune magazine on Aug 15, 2011, "These companies never made the transition from the magnified reflection of a single person to an institution with a life of its own." He suggests looking for 3 clues to find such companies. 'First one is - The 'One Man' wields power which is grossly disproportionate to his economic stake in the company. The second one is - The 'One Man' CEO is paid magnificently, usually much more than the industry norm. The third one is blatant family favoritism, including major related party transactions, often concluded under the radar. Any corporate governance reforms have to address this econo-cultural issue.

As Lans Thunell, CEO of IFC in Washington puts it, "Women make up 50 percent of the global talent pool, and boards cannot afford to overlook female candidates" The numbers bear him out. Hardly 15 % of board members of America's top 100 companies are women. The Economist makes the case for adding women as board members "There is a powerful business case for hiring more women to run companies. They are more likely to understand the tastes and aspirations of the largest group of consumers in the world, namely women. They represent an under fished pool of talent" It makes a strong case for correcting the gender imbalance in the company boards.

The report prepared by the Committee for Economic Development, a non-partisan public policy organization has made some important recommendations about compensation for senior executives. These are,

1. The company should have the right to recapture top executive bonuses if financial results by which they were justified turn out not to have been achieved when accounts are restated.
2. The compensation committee should be vigilant to construct pay packages that motivate executives to maximize the company's long-term economic value. For example, the compensation committee may want to spell out the long-term concerns they expect their CEO and other executives to address, such as employee retention, customer satisfaction, environmental sustainability, development of new products or markets, adaptability to change in public policies or other indicators of the company's long term health.

An article titled 'Are executives paid too much?' by Judith Samuelson of Aspen Institute and Lyn Stout of UCLA, in the Wall Street Journal on February 25, 2009, mentions "*...starting with metrics, we need new ways to measure long-run corporate performance, rather than simply relying on stock price in terms of investor communications, companies need to ensure corporate officers and directors communicate with shareholders not about next quarter's profits, but about next year's and even about next decade's......Incentive based pay should be based on long-term* *metrics, not one year's profits.*" While speaking on CNN Money on Feb. 19, 2012, Benjamin Barber gave very interesting statistics, *"In 1980, the ratio of CEO pay was nearly 42 times the pay of the average employee. In 2010 CEOs were paid 343 times the average employee."* This intra-company disparity is causing serious concerns about the stability of the American corporate compensation system.

Emerging Issues

CEO compensation in India has gone up very rapidly over the last 2 decades. Available public domain information makes it clear that the ratio between the effective compensation of the CEO and the average employee is getting skewed in favour of the CEOs very rapidly. Such a widening gap has become a major issue in the developed world economies. In the USA, over last 30 years the CEO to employee pay ratio has jumped up nearly 9 times. Over the last 20 years CEO compensation is galloping in India. With highly discounted stock options and significantly larger bonuses for CEOs, the earnings disparity within companies is heading for similar alarming levels. Five years back on May 24th, Prime Minister, Dr. Manmohan Singh gave a word of caution to the corporate sector on the high levels of remuneration of its promoters and senior executives. Good corporate governance requires the board to address this widening gap and target it to an optimum level for their company's specific situation.

Lans Thunell, CEO of IFC, has given interesting statistics about the gender imbalance on the company boards in India. Women make up less than 6 % of the directors of the top 100 companies traded on BSE. There is a clear need to accelerate the efforts to achieve a better gender diversity.

In India, successive rounds of corporate governance reforms have given a lot of attention to strengthening the board structure, particularly the role of independent directors. The board members of Indian companies have increasingly felt that corporate governance needs to be improved in India. Polls conducted over last few years have shown some interesting positions. Nearly 80 % felt that good governance should be practiced through a mix of principle based standards and moderate regulations. Nearly one third of them saw weak oversight as the biggest risk to governance in India. 20 % perceived management override as a major risk Over 70 % felt that the standards of risk management practices needed improvement.

Industry organizations have made detailed proposals about the selection process, roles and responsibilities of the independent directors. Orientation programme details have also been worked out to make the new directors more effective.

The proposals in this paper have built further on this existing base.

PROPOSALS FOR 'THE BOARD'

Newly elected board members shall have a formal orientation session covering their role, responsibility and accountability. The CEO, CFO and Company Secretary shall adequately inform the director of relevant company information. Company chairman shall have an introductory session with the director on board related matters.

1 Non-executive directors shall sign a non disclosure agreement with the company and agree to abide by the company regulations for prevention of insider trading.

2 An independent director shall chair the nomination committee of the board.

3 At any time, the number of executive/promoter directors on this committee shall not exceed 1/3rd of the appointed members.

4 The nomination committee shall strive for the composition of the board to achieve gender diversity and representation of minority shareholders.

5 The board shall ensure that the Employee Stock Option Plan of the company operates with transparency and has non-discounted, market based stock option pricing.

6 The remuneration committee of the board shall review the compensation policy of the company and provide guidelines to the company management to orient the policy towards long-term performance.

The remuneration committee shall review the internal compensation disparity and provide guidelines for reducing the level of disparity as required.

EMPLOYEE STOCK OPTION PLANS

Overview

Employee **S**tock **O**ption **P**lan **(ESOP)** is a compensation innovation that has gone away because of human greed and ineffective regulatory process. What started as a compensation tool for technology start ups and to circumvent the indirect salary ceiling in USA, has gone on to become the popular corporate vehicle for greed satiation. Judith Samuelson, founder of Aspen Institute in Colorado has put this very well. She says *"....As a result(of getting large numbers of stock options) managers were incentivized to focus their efforts, not on planning for the long term, but instead on making sure that share prices are as high as possible on their option exercise date... by whatever means possible."*

In another article 'Are Executives Paid Too Much', she writes, *"Top executives who receive equity based compensation should be prohibited from using derivatives and other hedging techniques to offload the risk that goes along with equity based compensation and instead be required to continue holding a significant portion of their equity for a period beyond their tenure."*

USA has strict regulation about the pricing of stock options. The options must be valued at the prevailing market price. This allows for aligning the interests of the shareholders and the top management. It is rightly felt that any price discounting will defeat the prime objective of stock options, namely 'The congruence of the interest of the shareholders and the top management.'

Emerging Issues

In India, ESOPs have become a major concern. India is one of the very few countries that still allow discounting of stock options down to face value. This means that the recipient of stock options can pay as low as 1 % of the prevalent market price. ESOP discounting was evident in Satyam and still happens in many other Indian companies. ESOPs have also led to widening of intra company income disparity and the resulting imbalances. In some companies, independent and nominee directors are getting a very large number of stock options. These make up a significant part on their overall income and wealth. Many Indian CEOs and directors have seen their earnings from stock options zoom so high that the salary part of the compensation is becoming insignificant compared to gains from stock options. As Judith Samuelson wrote, *"...this leads to shifting of their attention from long term company performance to the movement of stock price."*

Granting of severely discounted stock options to CEOs and other board members has changed the compensation scenario dramatically in India. Over the last few years the financial dailies are full of news like-

'Nominee director encashes stock options worth 3.5 crores ...'

'In the last 4 months, 3 CEOs sell stock options between 8 and 23 crores each...'

'Average CEO Compensation increases by 27 % in the same year the company profits fall by 33 %...' The extent of the stock options issue is obvious from these numbers.

At the same time, when correctly used, ESOP is an excellent tool for aligning the interest of senior employees and board members with the shareholders. Stock options need to be effectively regulated, since there has been rampant misuse in the past. In the absence of any price adjustments, stock options can be an effective tool to enhance the long-term focus of the company management and to align the interests of shareholders with those of company management. The proposed modifications to the current ESOP regulations will achieve that.

PROPOSALS FOR 'EMPLOYEES STOCK OPTIONS PLAN'

1 There shall be no issue price discounting of stock options for any employees or directors. ESOPs shall be issued only at the prevailing market price.

2 It is necessary to avoid artificial lowering of stock prices by senior management on the date of issue of the options. Therefore, ESOPs to board members and 'listed key employees' shall be issued on a fixed date every year. The date shall be decided by the company and disclosed to the shareholders in advance.

3 In order to link the vesting of stock options to long term performance of the company, 50 % of ESOPs granted to executive directors shall vest in 3 years and the other 50 % shall vest in 5 years after the grant date.

The stock options granted to non-executive directors shall vest as follows. 50 % of the options will vest in 3 years and the other 50 % shall vest 2 years after retirement from the directorship of the specific company or any other group company.

INSIDER TRADING

Overview

Since the advent of public limited companies, the problem of illegal insider trading has come up time and again. In every company, there are some employees who are in possession of information that can have a significant impact on the company's share price. When this information is not available in the public domain and if it is used, directly or indirectly to profit from a stock transaction, it becomes illegal insider trading.

Various countries have enacted laws to curb this activity. The United States was one of the first countries to enact and implement regulations against insider trading. It also has historically been one of the most rigorous implementer of these regulations. Insider Trading Sanctions Act of 1984, followed by the Insider Trading and Securities Fraud Enforcement Act of 1988 gave teeth to the American regulators to go after the insider trading cases. The top 5 convictions in the last 30 years netted total fines of over $ 120 million and jail sentences ranging from 3 to 11 years. In February 2012, the US Senate passed a pioneering bill named Stop Trading On Congressional Knowledge (STOCK) act, to bring lawmakers under the regulator's scrutiny for any insider trading. This is likely to be followed by other enlightened governments acting on similar measures.

Emerging Issues

Tough deterrents, of the level practiced in USA, have not been commonly used in India. Illegal insider trading is a vexing problem for regulators and stock exchange managements in India. The added parameters of substantial family holdings as well as very high quantities of stock options held by senior managers and key employees make it a bigger challenge to prevent insider trading.

PROPOSALS FOR 'INSIDER TRADING'

1 Insider trading regulations shall additionally apply to all persons listed below.

   a. The definition of covered persons shall include 'all promoters, all directors and 'listed key employees' owning more than 0.5 % of issued capital or 500, 000 shares' and their legally defined 'Relatives'.

   b. Each company shall work out the list of key employees who have substantial influence over the company's results. This list and its updates shall be approved by the board and submitted to the regulators by the company secretary.

2 In the event of any trade made by a 'Covered' person, the company secretary shall inform the regulator of such trade within 5 working days of receiving the information and post it on the company website, if available.

3 Annual summary of all trades made by 'Covered' persons shall be included in the annual report.

4 The penalties for insider trading convictions shall increase proportionately for such trades in companies with net assets of over Rs. 100 crores.

5 The person convicted of insider trading shall be disqualified from taking up any board membership for the next 10 years.

RISK MANAGEMENT

Overview

The 2008 economic crisis plunged the western world into a severe economic recession. One of the major causes was the total breakdown of risk management in the corporate world as well as in other organized entities. There were many factors, which caused this breakdown of risk management.

Incentive cycles got shortened. Large bonus payments were made on the basis of quarterly results. Getting results for the quarter using any means whatsoever, became the focus of most frontline persons who were dealing with high risk, high gains products. There was no claw back provision in most cases when such large bonuses were paid. If the stellar quarterly performance turned out to be a disaster later, the bonus could not be recovered. In many situations, the higher levels of management did not understand the complex financial instruments as well as the people who were creating and using them. The managers were managing those who knew far more than they did. This led to the inversion of the risk pyramid. The supervisor could not intelligently question the person who was taking risks. All these resulted in the 'profit is mine and loss is yours' style of risk taking and a breakdown of the risk management process.

Emerging Issues

This extreme situation happened in the financial sector. But all these factors are not uncommon to other industries. High growth economy often fosters high risk taking behavior. 'Current Quarter' focused managers prefer the risk-taking racehorse who produces big gains for the short term, more than the risk-averse workhorse who produces steady results. Rapid growth often masks risk failures, and reckless risk taking culture proliferates.

Most Indian companies are riding the high tide of the economic boom. A number of these are technology driven. Others are upgrading the technologies, which they use. In many industries, managers are managing those who know more than they themselves do. Some companies are depending on the risk assessment done by persons who have a short association with the company. The potential risk assessment process is commonly bypassed even in case of major decisions.

Besides the business risks, many companies are ill prepared for handling unexpected disasters. If plans for handling natural calamities exist, employees are often not aware of the details. Take the case of a common calamity like a fire. India's history of handling of public fires has been dismal. From the Upahaar Theater in June 1997 to the recent AMRI hospital fire, bad corporate governance coupled with inadequate emergency readiness magnified these avoidable disasters. Emergency handling is one area where western societies are doing a much better job. It has become an integral part of their institutions newer technologies are being used to improve the institutional readiness for major natural disasters. Feb 27, 2012 issue of Fortune magazine gives information about an online disaster preparedness tool called 'Ready Rating' offered by American Red Cross. IT savvy Indian industry can utilize such new technologies to improve their preparedness.

It is possible to introduce the basic risk management process for every significant decision, with a commonly practiced 4-step Potential Problem Analysis process -

1 Anticipate possible mistakes within and outside control of the team
2 Assess gravity and probability of risk arising from these mistakes
3 Plan for mitigation of risk to a level below the acceptable threshold
4 Provide ready tools for action and to monitor occurrence of risk

IT has permeated the daily operations of most Indian companies. In many cases the risks associated with the company IT systems are underestimated and more often not prepared for. Degradation of business as a result of IT system breakdowns is a common phenomenon. With different components of the IT network being handled by separate agencies, the risk of out of control breakdown increases. When the company moves to mission critical applications, the IT related risks increase by the order of magnitude. Rapidly evolving areas like 'cloud computing' and use of social media for work is bringing in a totally new set of risk parameters.

Risk Management has therefore become a very high priority area of corporate governance and needs elevated levels of focus.

PROPOSALS FOR 'RISK MANAGEMENT'

1 The company shall set up a Risk Management policy to cover both internal and external risks. This policy shall include processes for identification as well as for mitigation of risks.

2 The Risk Management policy shall be periodically reviewed by the board.

3 The company shall nominate individual risk monitors for every major risk.

4 The company shall have documented plans in place for handling natural disasters like flood, earthquake, cyclones etc.

5 The company shall communicate disaster-handling plans to all employees.

6 The company shall set up effective measures to ensure physical safety and security for all personnel and assets.

7 The company shall take appropriate measures for IT security to protect itself from cyber attacks and other intrusions.

WHISTLEBLOWER PROCESS

Overview

Many fraud cases against companies were successful because of the critical evidence produced by the whistleblowers from within. The regulatory and investigative agencies would have found it difficult to initiate and conclude actions, had it not been for the triggers provided by the whistleblowers.

United States was one of the early implementers of whistleblower regulations. It started with the False Claims Act proposed by Abraham Lincoln in 1862 (strengthened in 1986). It was followed by the Whistleblowers Protection act of 1989 (amended in 1994) and the Sarbanes-Oxley act of 2002, which came about after the mega corporate scandals at companies like Enron and Worldcom. This act makes it mandatory for a company board to put in place whistleblower policies that include a definition of whistle blowing, the individuals covered, non-retaliation provisions, confidentiality processes and enforcement measures. Many countries like UK, Australia, New Zealand, South Africa and others have come up with their own whistleblower related regulations.

Companies which have a well-run internal whistleblower process have found it greatly beneficial for improving employee morale as well as management effectiveness. It is necessary for the potential whistleblower to have a trust in the process as well as in the person who handles the information. The users of this process must experience a quick initiation of action by the process coordinator. This is a very sensitive stakeholder relationship activity. There have been some attempts to outsource the whistleblower process. Such outsourcing has its own upsides and downsides.

Emerging Issues

India has lagged behind other countries in implementing an effective whistleblower regulation. Comparing 2 cases of whistleblowers in India and Australia, Aditi Datta wrote in' The Hindu' on 3rd February 2004, *"Both cases are classic examples of whistle blowing. Both men were insiders who, coming to know of corruption and malpractice in their organizations, brought it to light – something that the others in their departments did not dare. Their circumstances too were similar... The point of divergence comes only when we look at the treatment meted out to whistleblowers and the consequences that followed." In India Satyendra Dubey was murdered. Just two days later, in Australia Andrew Wilkins was presented with the 'Whistleblower of the Year' award."*

The Indian whistleblowers have to struggle with the contradiction between the whistleblower regulations protecting their identity and the RTI provisions revealing their names. As the former CVC N. Vittal put it in

2006, *"Here we see a classic example of the path to hell being paved with good intentions... The simple solution would be to make a provision in the Right to Information Act itself that the identity of the whistleblowers will not be revealed under the act."*

The nation is watching the progress of the Whistleblowers' Protection Bill 2011, which seeks to provide adequate protection to whistleblowers. The corporate sector can initiate action at the micro level, to set up internal whistle blower process as part of their corporate governance initiative. The advent of the information age has provided a great opportunity to implement effective whistleblower process. The speed and anonymity provided by IT tools is a great advantage in making the process work effectively.

PROPOSALS FOR 'WHISTLEBLOWER POLICY'

1 Company shall set up an internal whistleblower process, coordinated by a senior manager, who directly reports to the CEO. Safeguards shall be built in the process to ensure that whistleblower identity remains confidential and in case it has to be revealed, then to ensure that safeguards are in place, as part of the process to protect the whistleblower from persecution/victimization by management.

2 In case of complaints involving non-compliance with laws or about matters relating to executive directors, the complainant shall have access to the chairman of the Corporate Governance committee. The committee chairman shall initiate immediate steps to investigate the complaint, resolve the issue and report the details to the board.

INFORMATION TRANSPARENCY

Overview

Transparency is one of the key supporting pillars of good governance. Lack of information transparency leads to distrust between stakeholders, corruption and inefficiency within organisations. At the other end of the transparency spectrum was the run-up to the 2008 economic crisis. A key cause of the derivatives led collapse, was the near blackout of information about the underlying housing loans. It blindsided even the savvy investors around the world. Real value of the toxic asset backed securities remained a mystery because of missing and inconsistent loan data. The result of this non-transparent activity is now painful history.

What is true for markets at the macro level is also true for companies at the micro level. Well-governed companies around the world are significantly more transparent than the others. The coming of information age has provided companies with cost effective tools to increase transparency both within and outside. IT technology helps companies to achieve selective transparency to suit business requirement.

Emerging Issues

In India, the central and state governments have set up e-Governance initiatives, RTI act, social audit of rural development schemes etc. Transparency achieved through e-Governance initiatives has made a significant impact in the working of the government, by reducing corruption and improving service and efficiency. Transparency in the ways that companies manage and oversee political funding is a must for cleaning up the corruption problem.

The disclosure initiatives in the corporate world are yet to keep pace. Many are still grappling with information transparency issues like -

1 Stakeholders have limited, periodic access to key information
2 Currency and authenticity of stakeholder information is not guaranteed
3 Accountability for the information gateway is diffused
4 Policy and process documentation not accessible to concerned employees
5 Effective channels are not available for employee suggestions and complaints
6 Voluntary disclosures are rarely initiated

The well-governed companies have implemented information transparency in dealing with different stakeholders. These initiatives such as full updates for independent directors, quarterly reports to shareholders with financial and other details, disclosure of non-compliance and other such initiatives have significantly improved their governance levels.

PROPOSALS FOR 'INFORMATION TRANSPARENCY'

1 Mission, Values and Goals of the company shall be communicated to all employees.

2 Work process details shall be available in writing with the employees and stakeholders who are carrying out that process.

3 The company shall provide external stakeholders with updated, accurate and authentic information.

The company shall encourage bottom up communication from employeesby instituting structured programmes like suggestion schemes and feedback channel for problems. The corporate governance committee shall periodically review a summary of significant suggestions and feedbacks.

INNOVATION ECOSYSTEM

Overview

Today, more than at any other time, innovation has become a crucial factor in the success of Indian companies. Innovations in products, services, processes and business models are responsible for most of the success stories of this decade. These innovations have led to dramatic changes in efficiency, productivity, quality, use of resources, competitive positioning and market strategy. A crucial test for an effective innovation ecosystem is the way the company is able to translate these innovations into sound sustainable financial results. These innovations translate into benefits for one or the other stakeholder. Customers benefit from better products, society benefits from saved resources, shareholders benefit from the improved results and so on.

Emerging Issues

Several Indian companies have made successful forays in the global markets. Many of these have been achieved through acquisitions. Significantly larger growth in the coming years will be achieved by competing with highly successful global corporations in both Indian and global markets. Successfully implemented innovations have made these corporations the winners in the global marketplace. Indian trans-national corporations will achieve sustained global growth by synergizing their strategic acquisitions with an ongoing pipeline of actionable innovations. This combination will provide for ongoing long-term success. The stakeholders will benefit in a big way from this business model. An effective Innovation ecosystem is an important corporate governance parameter for the companies in satisfying the aspirations of their stakeholders.

The current situation in India is full of internal dilemmas within organisations –

- Short term profit wins over investment in innovation: "My shareholders don't value innovation, they prefer larger dividends"

- There is no perceived need for innovation: "Current level of innovation will easily achieve my business goals"

- We are already innovating: "With right programme already in place, innovation will happen"

- Collaborative innovation projects have not done well: "Sharing innovation data, loses its confidentiality"

Besides these perceived issues, some other shortcomings also exist –

- R & D investment % is lower compared to similar % spent by global corporations

- There is low availability of internal talent for mentoring innovators

- Failures along the path to innovation are not easily digested

- Knowledge is seen as a tool for increasing self importance and is not easily shared
- Culture gap between industrial and academic ecosystems is wide
- Very few companies have succeeded in nurturing 'intrapreneurs'
- Innovations that cater to the elite are supported, but not inclusive innovations

PROPOSALS FOR 'INNOVATION ECOSYSTEM'

These proposals are geared towards elevating the focus on innovation within the organization and providing tools for a board level review. This elevated focus is a key factor in improving effectiveness of the innovation ecosystem within a company.

1 The company shall set up an innovation committee of the Board to review all innovation related activities.

2 The innovation committee shall periodically review innovation eco system of the company using parameters like –
   - R & D Spend and project funding process
   - Incentives and process for 'Ongoing improvements / IP creation'
   - Long term technology and market roadmap
   - IP awareness at all levels and use of external IP professionals
   - Strength of CTO organization
   - Lead taken by company employees in professional bodies and Standards committees
   - Close interaction with students and faculty at reputed universities and research institutions
   - Support and mentoring structures available for 'Intrapreneurs'

SOCIAL AUDIT

Overview

Nobel prize winning economist Dr Joseph Stiglitz writes in his book 'Making Globalization Work', *"...in an unfettered market economy private incentives are often not aligned with social costs and benefits – and when that happens, the pursuit of self-interest will not result in the well being of the society... Markets, by themselves, lead to too little of some things, like research, and too much of others, like pollution."*

Business policies and practices have significant social consequences. Normal business activities like employment process, human capital development, work safety practices, disposal of industrial waste, management of natural resources, consumer interaction and many others are constantly impacting some element of the society in which the business operates The information age has brought on a major transformation in the management of transparency. Corporate policies towards a whole range of stakeholders have become an essential element of a company's sustained long-term growth. Successful leaders of the new economy will be the ones who effectively integrate sound relationship with stakeholders into their business practices.

One of the most successful CEOs, Howard Schultz of Starbucks, was recently asked a question about corporate social responsibility, *"Is it not the role of the corporation to maximize profits for the shareholders, who in turn can use the proceeds to do good in the world, if they choose?"* He emphatically replied with the conviction of a preacher, rather than the caution of a CEO *"Companies should not have a singular view of profitability. There needs to be a balance between commerce and social responsibility... The companies that are authentic about it will wind up as the companies that make more money."*

A typical audit process usually starts by validating the company's social policy in areas like Human Capital, Corporate Citizenship, and Affirmative Action as well as other company specific areas. It is essential to involve senior management in working out social policies to ensure seamless integration into the company's management practices. The stakeholders relevant to each policy are identified. While designing the policies, it is also important to consider the cultural issues that can affect stakeholder groups. Each social policy is then assigned specific goals and verifiable indicators, preferably in consultation with the relevant stakeholders. The progress in the journey towards achieving these goals is communicated transparently to the stakeholders.

One good example of this process is the case of Ben and Jerry's, an ice cream maker in the USA. This company has been publishing their Social and Environmental Assessment Report for several years now. Examples of their social policy statements and one of the specific goals for each policy taken from the 2010 statement are given below -

1 **Policy –** Use our company to further the cause of peace and justice
  Specific goal – Use 'Fair Trade' certified ingredients as inputs

2 **Policy –** Make ice cream that is aligned with our values
  Specific goal – Use sustainable packaging

3 **Policy –** Take the lead in promoting global sustainable dairy practices
  Specific goal – Oppose use of recombinant Bovine Growth Hormone (r-GBH)

Emerging Issues

The Indian corporate scenario has gone through a number of changes over last seven decades. Soon after independence, moneyed Indian families, many of whom were new to the industrial culture, bought British companies. Later years saw the arrival Multi National Companies with their 'home country specified' management policies. The reforms of the 1990s gave a big boost to the entrepreneurial management culture and led to the globalization of Indian companies. As a result of globalization and the advent of the information age, these companies have come face to face with similar stakeholder pressures as in the other parts of the world. In his article 'Prepared for Corporate Ecosystem Valuation?' Sandeep Roy wrote on Jun 13, 2011, "*…There is increasing evidence that ongoing ecosystem degradation has a material impact on companies – undermining performance, profits, their social license to operate and access to new markets. … communities, NGOs, customers, consumers and shareholders are becoming increasingly conscious of the interrelationship between business operations and state of the ecosystems, and are demanding that these issues be addressed, reported and accounted for.*" The need for the 'stakeholder inclusive' management style has now become a necessity.

While many companies are aware of this new situation, very few have fully absorbed it into the way they are conducting business. They view the relationship with stakeholders as secondary rather than essential. In many businesses, social policies tend to be driven by the basic beliefs of the dominant shareholder, often the founding family member. All over Asia, more than 70 % of businesses are family dominated. The Indian corporate world is a mix of 3 major kinds of managerial influences. The family dominated, the professionally driven, and the government prioritized. This has led to disparate levels of societal interactions. The information age has also enhanced the pressure on the management to get more involved with the societal ecosystem.

Social Audit is the tool for these companies to become proactively aware of the relationship with their stakeholders. When conducted proactively, it tends to be a performance-enhancing audit, which eventually results in increased productivity, better market share and long-term investor interest. The other kind of audit, often labeled 'defensive audit', is aimed at preventing lawsuits, boycotts and other disruptive societal action. This paper concentrates on the proactive audit, which effectively minimizes the need for defensive audit.

It is important that social audit is done by a competent set of persons, whose own credibility is well established. There are some exponents of the quantitative approach, but many prefer the qualitative approach, which uses numbers like CO2 emission, % of women in top positions, CSR spend etc., and other qualitative inputs and then makes an overall

PROPOSALS FOR 'SOCIAL AUDIT'

1. Companies with turnover greater than Rs.1000 crores shall arrange for Social Audit of the company to be done by competent, independent persons

2. The Social Audit shall be conducted every 3 years and shall cover the company's internal and external activities in areas like-
   - Human capital
   - Corporate citizenship and CSR
   - Affirmative action in respect of people and environment

3. Results of the Social Audit and the progress made on audit issues shall be disclosed on the company website and in the annual report

Corporate Governance committee of the board shall review the Social and Environmental audit reports and actions taken.

CORPORATE GOVERNANCE INDEX

Overview

As the movement to improve corporate governance took root, a few key questions arose--what is the right model, how do we know that we are making progress, and how do we compare with others.

Modern day corporate governance activities started in the Western world. The Western governance models gained worldwide acceptance, especially because of the influence of transnational corporations and western management writers. But as Dr. Franklin Allen of Wharton puts it, *"A governance model with sole focus on shareholder value might not be the optimal way forward...The traditional literature on corporate governance suggests that the US/UK model is best. But now there is some pushback... The latest development... is that different corporate governance models can yield different economic outcomes... Perhaps what is needed is a hybrid approach that makes use of the best concepts pulled from a number of models."*

On the second question, the company boards would like to have a process which will enable them to give the direction, provide verifiable indicators and set up milestones to evaluate their company's progress in the area of corporate governance. Over the last decade, major company scandals like Enron, Worldcom and others have enhanced the spotlight on corporate governance. As Brown, Muchin and Rosenman wrote, *"For good reasons, companies and their boards are searching for bragging rights to good, better or best corporate governance practices... This increasing focus on governance has also resulted in a proliferation of published rating systems that rank on an absolute basis, and analyze and compare the relative corporate governance practices of public companies."*

This field now has many players. Agencies like ISS, GMI, S & P as well as international agencies like IFC rate overall corporate governance with their own proprietary rating scales. Specialized agencies like IR Global Rankings evaluate only limited aspects of governance. The wide spectrum of players has led to a confusing variation in factors, norms and standards of evaluation.

Emerging Issues

In India, the corporate governance scene has been evolving over a long time. Initially, it was driven by the strong value system of the group founders and the Indian subsidiaries of well-governed transnational corporations. As stock markets evolved and transparency became necessary, various codes of conduct evolved and corporate governance regulations became mandatory. Like the board members of the corporations in the Western world, the Indian counterparts were also looking for some credible certification to give visibility to their own good corporate governance practices. In 2002, SEBI initiated with the 2 rating agencies CRISIL and ICRA to develop their own proprietary rating system. Later, it was felt that there is little commonality of norms or rating parameters between the two and an issue was raised in March 2003, that one agency was perceived to be more liberal than the other. This is an inherent problem of multiple agencies evaluating a subjective issue and competing for the same market.

Some Indian companies adapted the western, shareholder centric governance model. But as Dr. Allen put it, there is a need to develop a specific model that is relevant to the local situation. Another factor prevalent in India is the large number of public companies, which are substantially family controlled. The western model is not the best fit here. Prof Joseph Fan of The Chinese University of Hong Kong feels that for such companies "…Simply importing international governance standards and forcing emerging market companies to adopt these standards will not be useful. The companies will remain opaque. We need to recognize the unique nature of these companies and their national and cultural context, and look at how to modify the Western governance models to fit them."

PROPOSALS FOR 'CORPORATE GOVERNANCE INDEX'

While developing the Corporate Governance Index (CGI), as a self-evaluation tool for the companies, two factors were paramount. First was having an appropriate governance model and the second was the ease of the rating process. It became clear that while it is necessary to take the regulatory approach to bring up companies to the minimum governance standards, the good managements walk the extra mile and voluntarily embrace higher levels of transparency. They practice good corporate conduct beyond what the law stipulates. The CGI provides a tool for company management to benchmark against the best in class and to highlight the areas that need improvement. The tool is simple in its approach and lends itself to self-appraisal by the board. However in the initial stages, the board may have to seek involvement of trained professionals to substantiate the evaluation and to help bridge the gap between 'what is' and 'what should be'. Verifiable statements have described each key area of corporate governance. These statements apply to Indian situations. In most cases these statements describe the 'What should be' conditions and therefore provide the company board with the direction and milestones for making the necessary changes.

At this point, making this index mandatory will be counter productive. The CGI needs to be accepted and practiced by company boards as a tool for self-evaluation and as a road map towards achieving improved corporate governance. This experience and the resultant improvement in corporate governance, is the target for the first phase. The movement of CGI into a normative standard should be considered over a period, based on the comfort level and acceptance by company boards and its successful utilization for improving governance levels.

The recommended timetable for implementation is –

Phase I

The **M**inistry of **C**orporate **A**ffairs **(MCA)** recommends, but does not mandate CGI for the first 3 years. During this period, the companies use CGI as a self-evaluation tool to map their progress in improving corporate governance. The proposed Investor Education and Protection fund is utilized to train a number of professionals on how to use the index as an evaluation tool and to enable the companies to improve their performance on the various aspects of corporate governance.

Phase II

Based on the feedback received from the companies and the trainers, the **C**orporate **G**overnance **A**dvisory **B**oard **(CGAB)** finalises the rating version of the **CGI**, which includes scale of importance for each factor. At this point, **MCA** makes it a mandatory rating for all public companies with a turnover of over Rs.1000 crores.

Phase III

After 3 years of Phase II, CGI is made mandatory for all public companies with a turnover of over Rs. 500 crores.

During all the 3 phases, CGI is available for all companies, irrespective of size, as a tool for improving their corporate governance practices.

Components of the Index

The factors that constitute the Corporate Governance Index are

1. Audit
- Statutory auditors are independent of any other relationship with the
- Company / Board members
- All audit queries are fully resolved in a time bound manner
- Statutory and internal audit reports are without any qualifications

2. Board
- Specified selection process for independent directors is followed
- Roles and responsibilities of all directors are clearly documented
- Code of ethics is accepted and followed by all directors
- Board has sufficient gender diversity and representation of minority shareholders.
- Transparency norms and processes for disclosures are in place

3. Compliance
- Compliance with statutory and non statutory requirements is reviewed periodically by the board
- Adequate resources are provided for compliance related activities
- Incentive is provided for proactive action on compliance matters
- Non compliance for any reason is disclosed adequately

4. Innovation
- Company board has set up the innovation committee
- Innovation ecosystem is periodically reviewed by the company board
- Effective internal process is in place for continuous improvement
- Company facilitates and supports innovation activity at lower levels
- Relevant verifiable indicators like 'number of patents filed' etc. are set up

5. Rewards and Recognition
- Performance based incentives are in place
- Reward system gives sufficient importance to long term performance
- ESOP details are fully transparent to all those who are covered
- Stock options are issued at market based, non-discounted pricing

6. Risk Management

- Risk identification and mitigation process is in place for both Internal and External risks
- Risk monitoring individuals have been identified for each major risk
- Disaster handling plan is documented and communicated to all concerned stakeholders

7. Security, Safety and Protection

- Effective measures are in place for physical safety and security of all assets and personnel
- Appropriate measures are in place for IT security and against cyber threats

8. Sustainability and Social Audit

- Environmental audit is carried out and actions are taken on queries
- Company interacts with community groups on environmental issues
- Proactive actions are taken on long term sustainability issues
- Social audit is carried out by competent independent persons
- Results of the social audit and actions taken are communicated to shareholders

9. Stakeholder Transparency

- Transparency is practiced in communications and actions with all stakeholders including Customers, Employees, Regulators, Shareholders, Society and Vendors
- Stakeholder feedback is sought as input while forming policies

10. Stock Market Interaction

- Effective internal process is in place to prevent insider trading
- Interest of minority shareholders is protected
- Process to ensure compliance is set up and adequately resourced
- All communications to regulators are adequate and timely

Rating Scale

The following rating scale is used

A: Effectively implemented in all areas

B: Effectively implemented in many areas

C: Effectively implemented in some areas

WHAT NEXT?

Improving corporate governance is a dynamic and evolving process. This paper has addressed the unfinished agenda for public companies. Many other sectors also need to address corporate governance issues. These include the Section 25 companies, NGOs, foundations, educational institutions, health care providers and many more. The government can take a leading role in implementing these proposals in public sector corporations. This can set an example for other companies.

The proposed **C**orporate **G**overnance **A**dvisory **B**oard **(CGAB)** is the vehicle, which will become the enabler for the Ministry of Corporate Affairs (MCA) to manage phased implementation of the proposals in this paper. MCA could consider setting up **CGAB** in 2012.

This paper can also form a basis for MCA to start a national dialogue on the Company Bill 2011. The structure and format of the paper makes it an ideal document for this purpose. These sessions can be held during 2012.

Pune **I**nternational **C**enter **(PIC)** also proposes to prepare a phase II document for expanding good corporate governance to other sectors. This document can be presented to MCA in 2012.

PIC is ready to work with **CGAB** during 2012 / 13 for the implementation of Corporate Governance Index **(CGI).**

MCA can take steps to implement the early action proposals in public sector corporations in 2013 and follow it up with other companies.

Implementing these actions will usher in the era of good corporate governance in India much faster.

ANNEXURE I: Example Of Application Of Corporate Governance Index

This annexure is provided as an example of how to apply the Corporate Governance Index to a company. Autobits is a fictional public limited company. The Index is used to ascertain the state of corporate governance in Autobits, using the information given in the case. The evaluation is available at the end of the annexure.

The case of 'Autobits Ltd'

During the tumultuous period following independence, Kanwaljit Singh's parents migrated from Lahore to Pune and set up a business dealing with automotive spares. Under Kanwaljit's leadership, this business flourished and his sons Surinder Singh and Kripal Singh joined him. As the business expanded, they started a factory to manufacture automotive components, for Original Equipment (OE) and After Market (AM) sectors. With the fast growth of the auto sector, the company's turnover went up rapidly and they converted the private limited company Autobits into a public listed company. Majority of the shareholding is with the family, with many of Kanwaljit's friends and other small shareholders make up the rest. The Singh family members continue to increase their stake periodically by purchasing shares in the market, often when they are aware of major orders in the pipeline. Autobits is aiming for a turnover of Rs. 300 crores next year.

With the boom in the Indian auto industry, Autobits has become very profitable. The shareholders are very happy with the high dividends and occasional bonus shares. The share is trading at over 50 times its face value. Every AGM is followed by a lavish lunch at the best restaurant in Pune. Whenever any shareholders come to visit the factory, they are treated with great hospitality.

Kanwaljit is the Chairman of Autobits. Surinder is the Managing Director and looks after Operations and Finance. Kripal is the Joint Managing Director and looks after Sales and Human Resources. Kanwaljit believes that it is the founder's privilege to run his company in the best interest of the owners. He is well respected by his employees. The senior management team consists of long serving loyal managers, who have grown with the company. The company secretary is a long time loyal assistant of Kanwaljit, and was helped by him to acquire the necessary professional qualifications.

Mangers are given stock options priced at face value of the stock. This has ensured loyalty and long service. The remuneration committee finalizes the SOP policy, with informal inputs from Kanwaljit. Salary structure for the sales staff has a very high % of bonus based on annual sales. This occasionally results in bad debts and pseudo orders. The sales staff tends to go after high volume sales in the OE sector, rather than in the high profitability AM sector. Surinder has recently set up a process to deduct pseudo orders and the old outstanding debt while calculating the year end sales bonus. Kripal is unhappy about this change and feels that it will adversely affect the sales. Every year the high performing sales staff and leading distributors are taken to a resort, along with their wives. The suppliers meet annually at a Pune hotel, where quality improvement and cost reduction are the main themes. Many of the distributors and suppliers have been with Autobits for many years.

Kanwaljit believes in looking after loyal employees. The company gives loans to long service employees and scholarships to their children. Kanwaljit's wife *helped the workers' wives to set up a co-operative, which supplies food to the workers canteen. Her activities with the spastics' society and a girls' orphanage are well supported by Autobits. Kanwaljit spends one day every week at the factory. On this day, any employee, who needs any help or has an unsolved problem, is allowed to contact him.*

Surinder has modernized the factory significantly over the last few years. Autobits has an excellent record of observing all health and safety regulations and provides employee health benefits, which are better than those provided by the surrounding industry. Surinder is concerned about likely business risks and the effect of natural disasters. He has set up a risk management committee, chaired by the CFO.

Rakesh Khanna, partner of the company's statutory auditors, is Kanwaljit's golfing partner. His brother-in-law's nephew Raman Kapoor, a well-known lawyer, is an independent director on the board of Autobits. The audit queries are promptly resolved and statutory audits are completed without any qualifications. Autobits has outsourced the internal audit to another CA firm. There have been some awkward audit queries and qualifications from few internal audits, but they have been resolved quickly.

The audit committee is chaired by Raman Kapoor and the nomination committee is chaired by retired Industries Commissioner S Sankaran.. Director of the local business school Dr. Banerjee, is the chairman of the remuneration committee. Kanwaljit informally attends all committee meetings. Each director informs the board about the working of the area, they are focused on. Surinder always keeps the board informed about all operations and finance related areas, including disclosures and any non-compliance.

Three years back, Autobits appointed a new board member Shashi Sathe, who retired as director of the Automotive Research Association of India. He has helped Surinder to set up a small group, which has developed an indigenous safety air bag system in collaboration with a large Indian auto company. This air bag is now fitted on the cars manufactured by this auto company. Autobits operates an employee suggestion scheme and implements good suggestions. Shashi Sathe treats this innovation activity as his baby and proudly tells the board of every achievement .The IT system in Autobits has a spotty record and there are frequent issues affecting data management and still requires a parallel manual system.

Surinder's son Amarjit ha done his MBA from Wharton and has recently returned to India and has joined Autobits. During his stint in USA, he developed a close friendship with a classmate, who has now joined a large MNC auto component manufacturer. Amarjit is initiating a collaboration plan with his friend's company. Autobits will part with some shareholding to this MNC in return for access to latest technology and to export markets. This MNC has a record of good corporate governance practices.

Amarjit feels this would be a Quantum jump for his family's business and wants to assess corporate governance situation in Autobits. He wants to improve it to a level acceptable to the MNC collaborator. He is using the CGI to make his evaluation.

Evaluation using Corporate Governance Index

The scale is –

A: Effectively implemented in all areas

B: Effectively implemented in many areas

C: Effectively implemented in some areas

Amarjit expects Autobits to get mostly B *and a few* A *evaluations.*
This is what the evaluation turned out to be

Area	Evaluation	
Audit	**C**	Although all queries have been resolved in time, they have a recent history of internal audit qualifications. Their statutory auditor and the chairman of audit committee are well connected, although not 'Related' within the legal definition.
Board	**C**	The roles and responsibility of directors is clear. The chairman controls the selection process. There is insufficient diversity. Disclosures are made regularly.
Compliance	**A**	The compliance process is well managed in terms of actions as well as disclosures.
Innovation	A	The innovation ecosystem is well above the industry average, both in terms of the process and the results.
Rewards	B	Performance based incentives, with one-year perspective and claw back provisions for bad sales or debt is positive. Operation of the ESOP is arbitrary and face value based.
Risk	A	Risk is being well managed and the risk monitor is identified.
Safety/Security	B	Physical safety and security aspects are effectively managed, but the IT systems have not yet matured.
Social Audit	NA	The size of the company does not require Social audit.
Stakeholder	B	There is periodic interaction externally, but internal process is still run on feudal lines.
Stock Market	C	There is no process to identify or prevent insider trading. Minority shareholder interests are secondary to the family interest.

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