3 ISSUES AND CHALLENGES OF CORPORATE GOVERNANCE

CHAPTER OUTLINE

Corporate governance is a dynamic process. With the passage of time new issues emerges which bring the challenges for the practitioners and policy makers. This chapter elaborates the following issues and challenges of corporate governance:

- Effectiveness of Independent Directors
- Board Duality
- Board Diversity
- Insider Trading
- Credit Rating Agencies
- Whistle Blowing
- Shareholders' Activism
- Role of Institutional Investors
- Proxy Advising Firms
- Class Action Suits
- Governance of Family Entities
- Governance of Multi-National Corporations (MNCs)
- Gandhian Trusteeship

LEARNING OUTCOMES

- To comprehend the recent dimensions of corporate governance which are capturing the attention of policy makers.
- To identify the challenges of corporate governance.
- To form opinion on the contentious issues of corporate governance.
- To critically examine the solutions to the challenges of corporate governance.

Effectiveness of Independent Directors

The major role that independent directors play in a company broadly includes improving the overall corporate governance framework and risk management processes of the company. The empirical evidence in different jurisdictions point out a significant improvement in the corporate governance standards with the induction of independent directors. In the boards especially in family controlled and concentrated shareholding companies the presence of independent directors has ensured structured agenda, deliberate discussions, and compliance regarding board processes. One of the important roles of board is to oversee and ensure compliance of the company with the rules and regulations. Independent directors are legally liable for negligence and are required to exercise utmost due diligence over all the financial and executive decisions of the company they are associated with. They are expected to bring out, misappropriation, non-compliance with legal provisions, malpractices etc. in the company.

In case of Satyam computer scam the court imposed hefty fine on the independent directors. There are many cases including Enron, WorldCom, Dewan Housing Finance, IL&FS wherein independent directors not only came under scrutiny, but they dented their reputation also.

Independent directors act as monitor of controlling shareholders. Independent directors prevent business decisions that are unfair to minority shareholders and other stakeholders. The audit committee headed by an independent director monitors all the related-party transactions, engage with the statutory auditors, and ensure integrity of financial reports. There are many instances wherein independent directors have blocked decisions which are not in the interest of the companies. There is no dearth of cases of independent directors asking tough questions and taking tough decisions despite pressure from the promoters or controlling group of shareholders. In fact, the institution of independent directors is well established and respected all over the world.

However, questions are often raised about the 'genuine independence' and effectiveness of independent directors. This is because these are appointed by the controlling group of shareholders or the promoters in most companies in Asia marked by domination of families. As independent directors are dependent on the families or the controlling group of shareholders for their appointment and continuation of appointment, it may impair their independence. In widely held big corporations of the US and UK, nomination process of independent directors is tilted more in favour of executives of the company particularly the CEOs of the companies who suggest the names of potential directors and finally the appointments are carried through the ‘nomination committees’ of the boards before approved formally by the shareholders in the annual general meetings. The independent directors may thus become dependent on the CEOs or chairman of the companies for their continuation/re-election.

Despite the prescribed independence criteria, some independent directors may have past or ongoing associations with the company's promoters or management. While these relationships may not be classified as “material” under the legal definition of independent director, in many cases it impacts judgment and decision-making of the independent directors. In state run public enterprises wherein political workers or persons loyal to the political party in power are obliged by offering them independent directorships in the companies, subconscious biases, affiliations, and loyalties, or undue familiarity sway judgment diluting the rigour and neutrality expected of their role. It gives rise to a fundamental issue of independence in fact (real independence) and independence in appearance (perceived independence).

Leaving the issue of ‘independence’ aside, doubts are also expressed on the efficacy of independent directors. As independent directors may be engaged in activities other than directorships in companies, they have limited time at their disposal to participate in board processes effectively. When making decisions, these directors have to rely on the information presented to them by the executives of companies. In some jurisdictions, directors have a legal right to inspect records of companies. Yet time constraints generally render this right ineffective. Many a times, independent directors lack proper training and orientation to influence board decisions. Given these constraints, independent directors can hardly initiate much of the corporate strategies or policies or bring to fore ‘independent and objective judgments’ to ensure that corporate decisions are made in the best interests of all the shareholders.

Failure of board of directors especially independent directors is the most common governance failure noticed in various corporate failures whether it is Enron or WorldCom or Parmalat or the Satyam. Some of the cases are as under:

(*i*) Enron Corporation was an American energy, commodities, and services company based in the USA collapsed in 2001. On paper, Enron had a model board of directors comprising predominantly outsiders with significant ownership stakes and a talented audit committee. In its 2000 review of best corporate boards, *Chief Executive* included Enron among its top five boards. Collapse of Enron may be construed as failure of corporate governance in particular the board of directors of Enron. The board failed miserably in its oversight responsibilities. The board had no clue of what the executives were doing. The directors failed to understand the related party transactions between Enron and SPEs. The board flawed in implementing proper systems of control and risk management.

(*ii*) The non-executive directors on the Maxwell Communication board, all reputed persons, did little in discharging their responsibilities. Unrestricted movement of funds across group companies, pledging shares of a company to raise funds for another company, excessive borrowings took place under the nose of the board. It appeared that the board was helpless in the face of larger-than-life personality of Robert Maxwell.

(*iii*) WorldCom had the board of directors consisting of 11 directors, eight of whom were independent. The board failed to fulfil its basic responsibilities. Acquisitions made by the company with the approval of the board, in many instances appeared to be opportunistic rather than part of the long-term strategic plan. The board's review of acquisitions was not comprehensive and left the company highly levered. These strained the financial structure of the company and complicated the analysis of the financial performance measurement. The board neglected in every aspect of the monitoring and oversight over the executives. The board failed to act or ignored accounting irregularities besetting the company more than 12 months before the company collapsed ultimately.

(*iv*) The debacle of Satyam Computer in 2009 demonstrated the ineffectiveness of independent directors. The board of directors of Satyam had well acclaimed persons as the members. The board failed miserably in its prime duty of oversight. The fraud had been cooking in Satyam for years together. On the behest of the promoters the board cleared the deal of acquiring family concerns of the promoters even though it was a major departure from the normal activities and expertise of Satyam. The high-profile independent directors chose to remain silent spectators to the pranks of the chairman of the company reducing themselves to the 'passive observers'. The board of directors of Satyam composed of a majority of independent directors, and the 'independent' Audit Committee of the Company miserably failed to exercise the important 'oversight' role and remained either ignorant of the whole scam or turned a blind eye to wrong practices ostensibly in fear of losing continuance of their job in the company from which they were getting hefty remuneration. The Central Bureau of Investigation report stated *"The members of the Board of Directors had acted as "rubber stamps", unwilling to oppose the fraud. Not a single vote of dissent has been recorded in the minutes of the Board meetings*[i]*".*

(*v*) One of the important roles assigned to independent directors is overseeing the policy implementation and ensuring that the business is carried on in the interest of the company. Infrastructure Leasing & Financial Services Ltd. (IL&FS) became highly levered and started making default in debt repayments in 2018. IL&FS had a board of directors consisting of eminent persons as independent directors and nominee directors from SBI, LIC and CBI. It seems that the directors in the company were either negligent or they lacked expertise in managing a complex infrastructure financing NBFC. The board failed miserably in managing the liquidity crisis that was brewing over the last four years. It is no wonder that, with such poor board oversight, IL&FS had ventured down a path of mis-governance, resulting in the company defaulting on its financial obligations.

Enhancing the Effectiveness of Independent Directors

(1) **Strengthening the Selection Process:** Policymakers and regulators should establish robust criteria for determining the independence of directors. In India there is an online data bank of the independent directors and the requirement to pass online proficiency test, but generally directors are hand-picked by promoters. The role of nomination committee of the board is important in setting standards for nomination of directors and screening the probable candidates.

(2) **Promote diversity on Boards**: Independent directors should be appointed with a diverse range of expertise and professional backgrounds. Companies should appoint directors from diverse backgrounds including gender and region. This will ensure that boards have a range of perspectives and experiences which can lead to better decision-making.

(3) **Enhancing the authority of Independent Directors:** The authority granted to independent directors does not commensurate with their responsibility. There is a need to augment the authority granted to the. A comprehensive board charter outlining the roles, responsibilities, and authority of independent directors should be established. The company needs to ensure that independent directors have timely access to accurate

i. Satyam CBI Report (http://www.topnews.com.sg/content/22973-satyam-scam-board-directors-also-party-fraud) and relevant information about the company's operations, financials, risks, and performance. This will empower them to make informed judgments and actively participate in discussions.

(4) Induction, Training and Development of Directors: A newly appointed director needs to undergo an induction programme to obtain essential knowledge about the company and its industry. For incumbent directors, continuous updating and professional development has become more important in the wake of growing complexities of the business and rapid acceleration of new regulations and legal requirements for directors. These programs should cover corporate governance best practices, legal and regulatory requirements, risk management, ethics, and sustainability. Companies should invest in continuous training and development programmes for independent directors to keep them updated on industry trends, best practices, and changing regulatory landscapes.

(5) Performance Evaluation: Regular evaluation of independent directors' performance, both individually and collectively should be undertaken by the entire board. This will identify potential conflicts of interest or shortcomings in fulfilling their responsibilities. The peer review can consider the constructive and less constructive roles individual directors play in discussions, the value and use of various board members' skill sets, interpersonal styles, individuals' preparedness and availability, and directors' initiative and links to critical stakeholders. This process should be driven by a board committee such as a nominating or governance committee. The continuation of independent directors should depend on satisfactory evaluation report. Absence of evaluation has often led to the situation of independent director being a 'puppet independent director' who are unable to perform the duties of directors as they lack skills inside the board rooms.

(6) Promote greater engagement between directors and other stakeholders, including shareholders, employees, and customers. This will help ensure that directors have a better understanding of the concerns and perspectives of the stakeholders. It will facilitate the directors to deliberate effectively in the boardrooms.

(7) Appointment of Lead Independent Director: When the Chairman of the board of directors is not independent or serves as CEO of the company also, there is a practice in some jurisdictions[ii] to designate an independent director as the 'Lead Independent Director' or Senior Independent Director' to serve in a lead capacity to coordinate the ac-

ii. The practice is mandated by the codes of corporate governance of the quite some countries. It is discussed in detail in chapter.

tivities of the other independent directors and to perform such other duties and responsibilities as the board of directors may determine. Lead independent director serve as liaison between chief executive office, senior management of the company and the independent directors. Such director also chairs the meetings of the independent directors without the presence of executive directors. This practice should be adopted by the companies to enhance the effectiveness of independent directors.

Board Duality

CEO duality is a governance structure where the CEO of a company also serves as the chairman of the board of directors. While CEO is liable for the performance of the company and for safeguarding the stakeholders' interests, the role of the chairman in a company is to run the board and ensure effectiveness of the board in implementation of the strategies. Both positions are equally important top-level leadership in a company responsible for the success and sustainability of the firm.

One of the most contentious issues in corporate governance is whether the positions of CEO and chairman may be combined in the same person or separated. The reforms in corporate governance which came largely in the wake of the corporate scandals all over the world, prescribe persistently a clear division of responsibilities between chairman and CEO of the company. Sir Adrian Cadbury, chairman of the Committee in the U.K. which investigated corporate governance issues in the early 1990s emphasised that 'the jobs of chairman and chief executive demand different responsibilities and perhaps temperaments. It is very much in shareholders' interests to ensure they are performed by different people'. The Cadbury Committee clearly recommended that "there should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision". Asserting chairman and CEO as two jobs and not one, many corporate governance codes and guidelines seek to institute independent chairman of the board of directors.

The primary role of a board of directors is to monitor and supervise the operations and ensure that the CEO and other executives run the company in the best interest of the shareholders. The CEO heads the management to implement the policies and strategies laid down by the board of directors. When CEO is also the chairman, he/she monitors her/himself, which may lead to abuse of power and position. This has given rise to many corporate scams and frauds.

The preference for the separate CEO-Chairman is largely grounded in the agency theory of corporate governance concerning the potential for managerial abuse. Cadbury Committee, 1992 and many codes of corporate governance strongly advocate that CEO of the company should not serve simultaneously as chairperson of the board. If chairman and CEO is the same person, it becomes more difficult for the board to provide an independent oversight of management or to evaluate the CEO or to express independent opinion on the management. An independent structure of the chairman is prescribed to facilitate objective assessment of the company and the top management of the company.

On the other side, the practicing managers rarely adopt the view that separation of the two positions is the superior structure. The CEO and the board chairman are two of the most positions in a company. Since CEO duality combines the responsibilities of both positions into one person, it cultivates a stronger and unified leadership at the top. The stewardship theory also suggests that the duality of the CEO and chairman joint structure provides unified firm leadership and removes any internal or external ambiguity regarding who is responsible for firm processes and outcomes. Duality offers the clear direction of a single leader, and a faster response to external events. The CEO-cum chairman is expected to have a greater knowledge of the company and the industry and have greater commitment to the company than a separate chairman.

CEO duality is more common in the U.S.A. than other part of the world. Although the current U.S. reforms do not mandate the separation of the roles of Chairman and CEO, they certainly reflect a desire to shift the power centre of the corporation away from the CEO to the Board. While Sarbanes-Oxley Act (SOX) addresses issues of managerial and board integrity through a number of provisions, listing rules of the NYSE and NASDAQ call for the boards to be comprised of a majority of independent directors.

In the UK on the other hand, the corporate governance code prescribes that the roles of chairman and chief executive should be split and further a chief executive should not go on to become chairman of the same company. There is a high level of compliance in the U.K., particularly among larger listed companies of the principle of separation of the two roles.

The Indian codes of corporate governance *viz.* CII code, Clause 49 of the Listing Agreement, Revised Clause 49 while silent on the issue of separation of chairman and CEO, linked independent (non-executive) chairman with the component of independent directors in the board of directors of company. The CII report recommended that if the chairman and CEO (or Managing Director) is the same person, independent directors should constitute 50% of the board, and 30% of the board in case the two positions are separate. The Kumar Mangalam Birla Committee's views on the subject were quite ambiguous. The committee believed the chairman's role should in principle be different from that of the chief executive, though the same individual may perform both the roles.

In the mandatory category of recommendations, the committee dittos the CII recommendations of linking non-executive chairman with the composition of board of directors of the company. The same provision was incorporated in Clause 49 as well reiterated in the Revised Clause 49 of the Listing agreement by the SEBI.

Based on the recommendations of the Uday Kotak Committee on Corporate Governance, the Securities and Exchange Board of India (SEBI) amended the SEBI (Listing Obligations and Disclosure Requirements (LODR)) Regulations, 2015. The amendment requires the split of the positions of the Chairman and Chief Executive Officer (CEO). In addition, the LODR Regulations provide that the chairman and CEO must not be related to each other. The amendment also requires that the position of chairman be held by a non-executive member. This regulation was to be applicable to the top 500 listed entities by market capitalisation from April 1, 2022. However, on the persistent demand of the corporate sector, SEBI made the rule of separation of CEO and Chairman voluntary.

Gender Diversity in Boards

In recent years board diversity has caught the attention of policy makers and practitioners, primarily driven by a concern for greater equality for men and women at the level of the board. It is also strengthened by the belief of behavioural difference in core values of female directors who would bring a different perspective in the board room.

The gender diversity in the board is advocated worldwide either through quota regulations or codes. The regulations in developed economies like Norway, Germany, Belgium, Iceland, and France pose a requirement of at least 40 per cent women on the boards of publicly traded firms. The governments of many other countries, like Australia, Britain and Sweden desire the listed entities to appoint an appropriate mix of women directors on the boards.

In quite a few European countries and in India, board gender diversity was introduced in listed firms by the legislation. A sustained pressure also came from national and international bodies.

In India, section 149(1) of the Companies Act, 2013 requires that the following class of companies must appoint at least one-woman directors on the board:

(*i*) Every listed company.

(*ii*) Every other public company having paid up capital of ₹ 100 crore or more, or turnover of ₹ 300 crore or more.

The Securities and Exchange Board of India (SEBI) Regulations, 2015 (LODR) also requires the boards of the top 1000 listed entities to appoint at least one independent woman director.

Presently, the composition of female members in the Indian boards is just 13.8 per cent which is much below the worldwide average. With Norway on the top with 41 per cent, France 37.2 per cent, South Africa 26.4 per cent, the global average is 16.9 per cent (Deloitte, 2018).

There are few theories which provide a strong rationale of women directors in the boardrooms. *Resource Dependence theory* posits the board's role to connect the firm with the external environment and bring various resources to expand the boundaries. It is argued that female directors bring a different set of knowledge, skills, and experience. A study of Bank of America Merrill Lynch (2018) also opines that gender diversity may provide a heterogeneous opinion in the boardrooms enabling the company to compete and adapt to changes in the industry. It has been pointed out that women bring 'competitive advantage' to the firm by dealing with the labour and product market efficiently. There is evidence which shows the experience of women in the boardroom valuable as they may understand consumers in some markets better than men. Thus, gender diversity on the round table enhances creativity and innovation.

The study of Forbes also advocated that a 'diverse board is better positioned to understand its customer base and the business environment in which it operates' (Forbes, 2018). Women directors make the board diversified to represent diverse customer base (The Economist, 2014). There are various psychological studies which state that women in leadership position enhance communication between different stakeholders and hence improves firm chance to perform better.

Gender role theory links gender with the behaviour and effectiveness of the individual. Women are regarded as risk-aversive and are less willing to take the extreme risk to earn phenomenal returns. There are many research studies which postulate the risk-averse nature of women. These studies concluded that firms which had more females in the top management team exhibited lower risk and better performance.

Many studies both by the researchers and consultancy firms have been undertaken to explore relationships between women directors and corporate financial outcomes. Many of these (Credit Suisse Research Institute, 2019, Bank of America Merrill Lynch, 2018, and Deloitte, 2018) unequivocally pointed out diversity as not only the right thing to do but also leading to 'smarter decision-making' impacting earnings significantly.