Corporate Governance through Clause 49 - The Letter and the Spirit

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Abstract:
While on the whole Clause 49 has been a positive development, it is far from a panacea for corporate governance problems in India. Market studies seem to suggest that the institution of independent directors seems to be adopted more in letter than in spirit in India.

I. Introduction – A quick look at Clause 49

In 2001, SEBI implemented the recommendations of the Kumar Mangalam Birla Committee through the enactment of Clause 49 of the Listing Agreements. This Clause 49 may well be viewed as a milestone in the evolution of corporate governance practices in India. They are applicable to companies with paid up capital exceeding 3 crores or net worth exceeding Rs 25 crores at any time, a specification that now covers over 85% of all BSE-listed companies. The Narayana Murthy committee worked on further refining the rules and Clause 49 was amended in 2004. It has been further amended in 2008.

The major mandatory areas of Clause 49 regulations are the following: (i) Composition of the Board of Directors; (ii) the composition and functioning of the Audit Committee; (iii) the governance and disclosures regarding subsidiary companies; (iv) Disclosures by the company; (vi) CEO/CFO certification of financial results; (vi) Report on Corporate Governance as part of Annual Report; and (vii) certification of Compliance of a company with the provisions of Clause 49.

The composition and proper functioning of the Board of Directors emerge as the key area of focus for Clause 49. It stipulates that non-executive members should comprise at least half of a board of directors. It defines an “independent” director and requires that independent directors comprise at least half of a board of directors if the chairperson is an executive director and at least a third if the chairperson is a non-executive director. (See table 1 for the evolution in the area of independent director in Clause 49). It also lays down rules regarding compensation of board members; sets caps on committee memberships and chairmanships; lays down the minimum number and frequency of board meetings and mandates certain disclosures for board members.

Clause 49 pays special attention to the composition and functioning of the Audit Committee, requiring at least three members on it, with an independent chair and with two-thirds made up of independent directors and having at least one “financially literate” person on it. It lays down the role and powers of the audit committee and stipulates minimum number and frequency of and the quorum at the committee meetings.

Apart from the issue of board independence, another major area covered by Clause 49 is disclosure. The areas where Clause 49 stipulates specific corporate disclosures are: (i) related party transactions; (ii) accounting treatment; (iii) risk management procedures; (iv) proceeds from various kinds of share issues; (v) remuneration of directors; (vi) a Management Discussion and Analysis section in the Annual report discussing different heads of general business conditions and outlook; (vii) background and committee memberships of new directors as well as presentations to analysts.

The CEO and CFO or their equivalents need to sign off on the company’s financial statements and disclosures and accept responsibility for establishing and maintaining effective internal control systems.

The company is required to provide a separate section of corporate governance in its annual report with a detailed compliance report on corporate governance. It should also submit a quarterly compliance report to the stock exchange where it is listed. Finally, it needs to get its compliance with the mandatory specifications of Clause 49 certified by either the auditors or practicing company secretaries.

Furthermore, Clause 49 a board committee with a non-executive chair should address shareholder/investor grievances. Finally the process of share transfer, a long-standing problem in India, should be expedited by delegating authority to an officer or committee or to the registrar and share transfer agents.

In addition to these mandatory requirements, Clause 49 also mentions non-mandatory requirements concerning the facilities for a non-executive chairman, the remuneration committee, half-yearly reporting of financial performance to shareholders, a move towards unqualified financial statements, training and performance evaluation of board members and perhaps most notably a clear “whistle blower” policy.

By and large, the provisions of Clause 49 closely mirror those of the Sarbanes-Oxley measures in the USA. In some areas, like certification compliance, the Indian requirements are even stricter. There are, however, areas of uniqueness too. The distinction drawn between boards headed by executive and non-executive chairmen and

the lower required share of independent directors is special to India (and somewhat intriguing too, given the prevalence of family-run business groups).

While clearly Clause 49 is more than about just board independence, this issue is clearly the most central one. As such, in this article we will focus largely on board independence and try to assess the effectiveness of Clause 49 primarily from that perspective.

II. The setting – the special corporate governance challenges of India

Though the parallels between the Clause 49 and Sarbannes Oxley are unmistakable, there are critical differences between the basic nature of the corporate governance problem in the home countries of these measures. The importance and role of independent directors vary with national socio-economic and legal environments and it is important to highlight these differences in order to better understand the corporate governance realities in emerging markets such as India. While in the USA, the fundamental corporate governance problem is "vertical" – i.e. protecting the shareholders from the grabbing hand of the managers – that in India is primarily "horizontal" – in terms of upholding the rights of the minority shareholders vis-à-vis the controlling shareholders.

This arises because managers have scant ownership and equity ownership itself is widely dispersed. In emerging markets, however, the corporate landscape is dominated by family-owned (and with few exceptions family-run) business groups, where the average equity share of "promoters" typically exceeds 50%.

The difference can hardly be made starker than by pointing to the fact that the NYSE exempts companies with 50% ownership by a single individual or group of individuals – termed "controlled companies" – from several key disclosure requirements. The basic premise here is that with such concentrated control, shareholders will have enough leverage over management to prevent most corporate governance abuses. As for minority shareholders they have enough protection in US corporate laws to provide them protection against potential expropriation.

In India on the other hand poor implementation of laws, the prevalence of "business groups" enabling majority shareholders to tunnel funds into fringe enterprises with higher cash flow rights, lack of direct reporting of audit committee to the regulator, and the lack a well-functioning market for corporate control all make the institution of the independent director the main safeguard that minority shareholders – particularly retail investors – have against self-dealing activities by controlling shareholders.

Of course, this assumes that the independent directors live up to their responsibilities as envisaged in theory. It is quite possible, however, that the institution itself gets corrupted and abused since the management in consonance with the majority shareholder ultimately select the independent directors in the first place. Since considerable skepticism prevails about the "independence" of independent directors even in developed markets, it is natural to extrapolate that the purported "independence" of such directors can only be further compromised in an emerging market setting like India where long-term familial and reciprocal relationships are usually relatively more common than arms-length contractual agreements. Furthermore, independent directors rely on the information provided by insiders to be effective; however, such information may not be easily forthcoming from corporate insiders who owe their allegiance to promoters/ controlling shareholders.

It is therefore important to invest some effort in examining the extent to which Clause 49 has affected the corporate governance reality in India. This, however, is not a simple task. For an aggregate level analysis, measures of corporate governance quality pose the first challenge – they are hard to define and quantify and almost never beyond debate. But even after agreeing upon such a measure, a simple before-after comparison would not work since the world has not remained static – the ceteris paribus condition – over the period during which Clause 49 has gradually been adopted by Indian firms.

An alternative to this direct approach is to appeal to the market's purported omniscience and record the market reaction to the news of adoption of Clause 49 on a firm-by-firm basis or on other related events – essentially an event-study approach. A few of these do exist and generally point to a positive impact, though one needs to be careful about a certain publishing bias here. Studies that find "no effect" would, in all probability, be harder to publish than those that find a result. Besides a careful scrutiny of the statistical methods in the detection and robustness of such effects is in order since the statistical weaponry put to use varies significantly across studies and has an important bearing on the reliability of the results.

Finally some circumstantial evidence on the issue can be gathered from the current state of affairs – the quality of the independent directors and their qualifications arguably suggesting their contribution and independence. While such an exercise will essentially be somewhat riddled with subjective biases, it is not wholly without value. Indian promoters can find ingenious ways of fulfilling the Clause 49 requirements with ornamental independent directors whose allegiance (or indifference) they can count on. (To be fair, this is true of American CEOs as well, but one may claim the level of media and regulatory scrutiny is higher in developed countries.)

III. Indian boards today – a few salient features

In 2010, with over half of all the Bombay Stock Exchange-listed companies reporting their board characteristics, a glance at the typical Indian boardroom can serve as a quick reality check before moving on to statistical analyses

of the impact of the provisions of Clause 49. Panels A, B and C of table 2 provide the necessary information. As is evident from these panels the typical boardroom has between seven and eight members with an average age of 55 years. Of these, about half — between three and four – are independent directors. They are slightly older – about 4 years older on average than the average age for all directors. So, for the reporting firms, on average, the 50% ID stipulation of Clause 49 is fulfilled.

Three quarters of the independent directors have served the firm for more than three years, the modal tenure lying between 3 and 6 years. Slightly less than two-thirds of the independent directors have post-graduate education.

If the average figures hardly seem unusual, the tails of the distribution can raise eye-brows. About 3% of the independent directors are over 80. 69 individuals below the age of 25 adorn these positions. 2% of them have not crossed the confines of their schools in terms of education. What expertise these individual bring to the boardrooms is best left to the judgment of the observer. A full quarter of the independent directors have been with the firm for more than 9 years, 18% for more than 12 years. How much independence they retain after such a long association is also a matter of debate. While the market-wide average may drown these features, it is here where compliance, in terms of board independence, seems to be only with the letter and not the spirit of Clause 49. To what extent this supposed board independence, i.e. the proportion of independent directors, is valued by the market as a measure of board effective would be the subject matter of the next section.

IV. The effectiveness of Clause 49 – evidence from event studies

Broadly speaking, the markets welcomed Clause 49, somewhat in contrast to the mixed response to Sarbanes-Oxley measures in the USA. Black and Khanna (2007) use an event-study approach to measure the stock price impact of the adoption of Clause 49 by Indian firms. Focusing on the May 7, 1999 announcement by SEBI about the formation of the Kumar Mangalam Birla committee when a sooner application to large companies was expected, they report that large firms that adopted these measures first witnessed a 4% (7%) positive price-jump in a two day (five-day) event-window beginning with the announcement day as compared to smaller firms that were required to implement the reforms at the same time. Clearly markets had put considerable hope in Clause 49.

Fast forward eight years, and the bigger question is whether the board independence brought about by Clause 49 has actually mattered to the market perceptions of corporate governance standards of the complying firms. A window for observing that effect was provided by the Satyam scandal – doubtlessly a corporate governance eye-opener. Chakrabarti and Sarkar (2010) have studied the impact of the Satyam scam on other firms and explored the relationship between board independence (and other standard corporate governance variables identified in the literature) and the post-Satyam abnormal returns of the firms. The results are mixed and raise more questions than they answer.

For instance in the aftermath of the first shock on Dec 16, 2008 when the Satyam board approved of the Maytas deal, which was doubtless about board ineffectiveness, board independence mattered on the margin but more importantly the characteristics of the independent directors have a favorable effect on market reaction: companies with independent directors with presumably greater expertise (proxied by number of multiple directorships) do better. Finally there is a large discount for companies belonging to business groups.

For the second episode, of the revelation of a long-standing accounting fraud on January 7, 2009, none of the board or audit committee independence related variables are significant, but indicators of quality of audit committee seem to matter in the .

Overall the link between board independence and market reactions has been tenuous at best. The natural interpretation of this finding is that markets attach little value to board independence as measured just by the proportion of independent directors. They are confident only of a few independent directors with impeccable reputation and qualifications. The average independent director inspires little faith in the market. It has limited faith in his ability and independence.

V. Conclusion

It is undeniable that Clause 49 has had a non-negative impact on the corporate governance reality of India. What is debatable is the positive-ness of the impact. While firms have generally complied with its carefully drafted letter, the overall effect on corporate governance, as reflected in the eyes of the market, has been on the quality of the board – extremely difficult to measure and stipulate as conditions. Clause 49 is undoubtedly an improvement on what existed before, but it is far from the silver bullet for corporate governance.

References

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Box 4: Major Revisions of Clause 49 of Listing Agreement with respect to Board Composition and Independence

Clause 49 (original)* February 21, 2000	Clause 49 (revised)** October 29, 2004	Clause 49 (revised)*** April 8, 2008
Board composition The company agrees that the board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors. The number of independent directors would depend whether the Chairman is executive or non-executive. In case of a non-executive chairman, at least one-third of board should comprise of independent directors and in case of an executive chairman, at least half of board should comprise of independent directors.	**Board Composition** *Similar as February, 2000*	**Board Composition** *Additional qualification for boards with non-executive chairman* "If the non-executive Chairman is a promoter or is related to promoters or persons occupying management positions at the board level or at one level below the board, at least one-half of the board of the company should consist of independent directors."
Determination of Independence 'independent directors' means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgement of the board may affect independence of judgement of the director.	**Determination of Independence** *Revised* For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who: *a.* apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director; *b.* is not related to promoters or persons occupying management positions at the board level or at one level below the board; *c.* has not been an executive of the company in the immediately preceding three financial years; *d.* is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following: (*i*) the statutory audit firm or the internal audit firm that is associated with the company, and (*ii*) the legal firm(s) and consulting firm(s) that have a material association with the company. *e.* is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and *f.* is not a substantial shareholder of the company i.e. owning two per cent or more of the block of voting shares.	**Determination of Independence** *Similar as October 2004*

* See Circular No. SMDRP/POLICY/CIR-10/2000, dated, February 21, 2000. http://www.sebi.gov.in/

** See Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 October 29, 2004. http://www.sebi.gov.in/

*** See Circular No. SEBI/CFD/DIL/CG/1/2008/08/04, dated April 08, 2008. http://www.sebi.gov.in/

Source: Sarkar, 2010

Table 2: Panel A

A quick look at Boards in India

Distribution Summary by Number of Directors

- There are a total of 18,958 directorship position on these 2,568 companies, giving an average of 7.4 directors per company.
- The maximum number of directors in any company is 19 (Bharat Heavy Electricals Ltd. and Larsen & Toubro Ltd.).

No. of Directors	No. of Companies	%
< 5	334	13
5 – 10	1,885	73
11 – 15	327	13
>15	22	1
Total	2,568	100

Based on 2,568 BSE-listed companies who have filed Information as on 30 April 2010

Distribution Summary by Age

- The average age of the directors is 55 years.
- The youngest director is aged 18 years (Mr.Dnyanaraj Sudhir Moravekar) and the oldest is 100 years (Mr.Munishwar Nath Sardana). 69 individuals are below the age of 25 years and 2,192 individuals are above 70 years.

Age	No. of Directors	%
25 & below	69	0
26 – 35	748	5
36 – 45	2,181	14
46 – 60	5,918	39
61 – 69	2,872	19
70 – 80	1,838	12
81 – 90	339	2
> 90	15	0
Not Known	1,356	9
Total	15,336	100

Source: www.directorsdatabase.com

Table 2: Panel B

A quick look at IDs in India

Distribution Summary by Number of Directors

- There are a total of 9,475 independent directorship position on these 2,506 companies, giving an average of 3.8 independent directors per company.
- The maximum number of independent directors in any company is 12 (Bank of Rajasthan Ltd.,The).

No. of Independent Directors	No. of Companies	%
< 3	509	20
3 – 5	1,639	65
6 – 10	355	14
> 10	3	0
Total	2,506	100

Based on 2,568 BSE-listed companies who have filed Information as on 30 April 2010

Distribution Summary by Age of Independent Directors

- The average age of the directors is 59 years.
- The youngest director is aged 22 years (Mr.Venkata Ramana Gopala Krishna Kavuri) and the oldest is 99 years (Mr.Nathmal Himatsingka). 8 individuals are below the age of 25 years and 1,568 individuals are above 70 years.

Age	No. of Individuals	No. of ID Positions Held	%
25 & below	8	8	0
26 – 35	250	250	3
36 – 45	854	932	12
46 – 60	2,577	3,093	35
61 – 69	1,821	2,515	25
70 – 80	1,325	2,043	18
81 – 90	234	327	3
> 90	9	10	0
Not Known	297	297	4
Total	7,375	9,475	100

Source: www.directorsdatabase.com

Table 2: Panel C

A quick look at IDs in India -- II

Distribution Summary by Tenure of Independent Directors

- Tenure of 6,955 (74%) Independent Directorship Positions is more than 3 years; 4,082 more than 6 years; 2,400 more than 9 years and 1,725 more than 12 years. Maximum tenure is 54 years.

Tenure	No. of Directors	%
< 1 Year	808	9
>1 - <3 Years	1,712	18
>3 - <6 Years	2,873	30
>6 - <9 Years	1,682	18
>9 - <12 Years	675	7
> 12 Years	1,676	18
Not Known	49	1
Total	9,475	100

Based on 2,568 BSE-listed companies who have filed Information as on 30 April 2010

Education of Independent Directors

- 63% of ID positions are held by post-graduates (and above). Conversely, 37% of ID positions are held by general graduates or below.
- 1,003 are Management Graduates (of which 120 are IIM graduates)
- 1,115 are Chartered Accountants, 273 are Company Secretaries and 162 are Cost Accountants
- 948 are Lawyers
- 124 are Medical Doctors
- 1,354 are Engineers

Highest Level of Education	No. of Individuals	%	No. of ID Positions Held	%
DOCTORATES	525	7	734	8
POST GRADUATES	3,757	51	5,181	55
TECHNICAL GRADUATES (B.E.,B.TECH.,M.B.B.S.,LL.B.)	909	12	1,173	12
GENERAL GRADUATES (B.A., B.COM. ETC.)	1,558	21	1,735	18
UNDER GRADUATES	56	1	66	1
SCHOOLING	181	2	196	2
NOT KNOWN	390	5	390	4
Total	7,375	100	9,475	100

Source: www.directorsdatabase.com