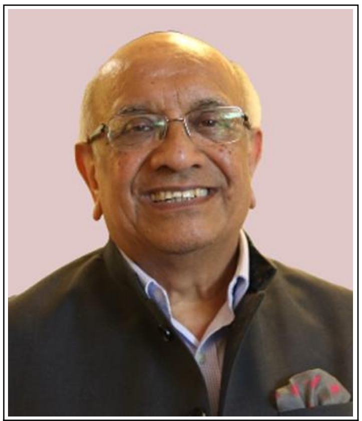
# Moderate Regulations - Increase Governance



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**Each time there is a governance failure the tendency is to add Additional regulatory compliance burden. While this may seem necessary - over time this becomes more "follow the letter ". The real governance comes when it is more about "following the spirit". Many Boards have adopted very good practices, which go far beyond the regulatory dictat to achieve this.**

**Over-regulation**

The government and regulatory authorities need to create an environment to build greater trust with companies and Boards and help ensure that the spirit of governance is as or more important as following the letter. Over the years with each new scam or governance failure new provisions/ laws/ requirements get mandated. Some may be necessary but in many cases they become a tick in the box and do not achieve the purpose intended. This has happened globally with Sarbanes Oxley and Dodd Frank Acts which got adapted by other countries including India. Often this leads to over regulation - putting unnecessary burden on companies, auditors as well as on regulators without achieving the desired impact. Managements spend most time in ensuring and reporting compliance and much less time on reviewing its outcome.

A good example of this is the CSR spending – which was initially recommendatory but is increasingly becoming over governed and regulated. Much before the Act, a large number of companies were voluntarily spending money for social causes. The new provisions did bring in focus on CSR but over the last two years more and more regulations including punitive provisions are creating unnecessary distress. A new guideline is also being stipulated that contributions by companies can only be to Section 8 companies and not to trusts and societies. It should be left to the companies to decide on who and how they support social causes rather than the last detail being mandated and micro managed. The Ministry of Company Affairs cannot determine who needs support - Oddly any CSR spent to the disabled sector other than for education does qualify as CSR.

Yet another example of over regulation is the recent RBI circular regarding responsibilities of the board of Directors in banks. Responsibilities of audit, compliance and risk have been proposed to be shifted from the executive management to the Independent Directors of the Board. This shall have serious consequences for both the Directors as well as efficient functioning of the bank. Independent directors cannot take over the role of executive management of companies. It would be increasingly difficult to find Independent Directors who would accept the onerous implications of some of these guidelines.

Yet another example is the databank of Directors created by the Ministry of Corporate Affairs in partnership with IICA, making it mandatory for directors to register and pay fees. This seems just a new revenue generation source for IICA, without any tangible gains and creating unnecessary processes. Compulsory passing of an exam as a pre-qualification of taking up a Board position may have good intention and has negative consequences. Board members come from diverse backgrounds and skills, do all have to learn law to pass an exam.

Due to COVID now but also earlier, a lot of Board meetings happen virtually thru VC. This happens the world over where Boards can do just audio conferences. However, the process of video recording and archiving is unique to India and is counterproductive. Conscious that everything is being recorded, cramps the style and prevents open transparent discussions and deliberations due to the apprehension that any confidential and differing views may at a later date be held against the company. This dysfunctional process compromises good governance and having an effective Board meeting. All this comes from old age colonial mistrust that Directors may not attend meetings and only mark their presence. This they could do even for normal physical meetings!!! If at all a proof is required (not sure why), the beginning and the end of the meeting could be recorded.

Similarly, for Directors tenure the law says max of 10 years and two terms. While having a time limit seems like a good process as it helps refresh the Board and ensure continued independence, the two terms limit seems like an over prescription as it takes away the flexibility of the duration of the terms – we may want some Board members for just three years and others for 10 years and may want more terms. In US the best practice is to appoint Directors and take shareholder approval each year with no prescriptions

The provision currently on hold of Chairman and CEO not being related is creating considerable issues particularly in the context of promoter driven companies. Somebody with majority ownership would want a family member as succession which this prohibits in a sense. This requirement should be done away with as it may only result in dummy Chairmen being appointed to comply.

I Regulation and Governance is a much researched area and is well documented. Good Corporate governance practices are shared in publications, by consulting firms, academic institutions and experts. Boards, however, have a responsibility to build trust with the regulators by following the right practices and the diligence required in discharging their responsibilities. If there is trust, then any single failure of poor governance will be taken as an aberration and the guilty punished - rather than increased regulation impacting all.

There are several practices which are followed enhancing the governance both in spirit and in letter. These could be adopted if we have strong conviction in them. This is not an exhaustive list but a few that have proven effective in practice.

The role of the Proxy advisory firms as an additional oversight could be significant. This process has started in India but still nascent in terms of impact. They add value through their analysis and comparing best practices. Since large investors follow their advisories for voting on key resolutions, this provides a good check and balance. Boards should increasingly pay attention to their analysis, findings and views. The proxy advisory firms should however need to remain truly independent and desist from also being consultants and advisors to the same very corporations, creating a conflict of interest, as is being felt and debated in the USA.

The Boards should have zero tolerance when it comes to any conflict of interest both at promoter, board and management level. Most issues of governance start with Boards overlooking or condoning conflict of interest. The conflicts are fairly obvious and evident and it is the role of the independent Directors to have open discussions on this. The promoters and management should not put the Independent Directors in an embarrassing position and prevent it at the outset. A full disclosure in this regard should be made in companies and over time this will become part of the DNA.

Boards need to take a well-informed position on any issue and should ask for any additional information, beyond the selective data that may be presented by the management. Boards should have direct access to management while being conscious of not asking for any market sensitive information. Managements too should have access to Board members. The executive management of companies should attend and participate in quarterly performance reviews and strategy sessions. The CEO and Chairman should encourage direct contact with Directors and not become unnecessary gatekeepers. Transparent and open relationships will lead to a healthier and effective relationship between board and management.

Boards should regularly meet in an executive session without the CEO/MD or any other executive. This helps the Chairman get an assessment of Board members candid opinion on areas of improvement and is able to take up these issues with the CEO one on one. Similarly the Audit committee (or surely the Chairman) too should meet with the statutory auditors without the presence of the CFO or the CEO and get a more direct and open assessment. This should not be construed as lack of trust with the CEO or CFO but as a process to improve effectiveness of the Board.

Board committees play a very significant role in governance and based on need, companies could form additional Board committees beyond prescribed by law. For example, for Customer Service, Marketing and Sales or for Technology and Cyber Security. Some of these have been mandated in the banking sector and add significant value. To get most of the committees the topics should be calendarised for the year and help cover the entire gamut of the Charter of these committees in a regular structured way. For every board committee, there should be a defined facilitator from Executive management like that we have the CFO for the audit committee, HR head for NRC etc.

One of the areas that gets less attention is the way minutes of the meetings are documented. They tend to be minimalistic and cover largely the statutory approvals. Minutes end up being written by the Company Secretary in a legal language often missing out documenting the richness of the discussions and deliberations. The rationale for taking a decision does not often get documented – though the decision does. This needs training and skill, to crisply document the deliberations beyond the outcomes. We do not have to minute the full proceedings but just the quality and essence of the discussions. The presentations made by management which were not part of the formal agenda papers should also constitute as part of minutes for future reference.

Boards spend enormous time deliberating CEO and KMP compensation. Periodic review of the effectiveness of the Comp plan needs to be done to ensure that it drives intended behavior and outcomes. It will be important to not only review the targeted total compensation but what is the realized compensation in the hands of the employee. This becomes particularly relevant when we have a higher proportion of variable pay and stock options. There may be instances where the organization has not delivered but the payouts are high and vice versa.

In summary, there needs to be a balance of Governance being driven by regulation and compliance and through sincere commitment to the spirit of governance by the Board and management. In the long-term, the market does reward companies with better governance. This can be done by building a higher level of trust between stakeholders. Regulations while are necessary should not become dysfunctional and managements and Boards have a responsibility to better govern to earn the trust.