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# Key Corporate Governance Considerations for India's Economic Development

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**Keynote Address by Phil Armstrong**

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The Institute of Company Secretaries of India

## ➤ Opening Comments

Honorable Minister, honored guests, Mr NK Jain, ICSI Secretary and CEO, ladies and gentlemen - it is indeed an honour to address you today at this 10<sup>th</sup> ICSI National Award in CG.

Before proceeding: I should add that since being based in the United States, I have become accustomed to the rather curious practice of having to qualify my talks with the disclaimer that the opinions I express are solely my own and are not necessarily representative of the organisation I represent!

Of course today is marked by the beginning of what should be an intriguing contest of skills between India and South Africa on the cricket field in Pretoria, South Africa.

Equally intriguing, is that this day two years ago, on December 16, 2008, India's then-fourth largest IT services company, Satyam Computers, headed by its Chairman, Mr. Ramalinga Raju, announced its plans to acquire Maytas Properties and Maytas Infrastructure in an ill-fated attempt to prevent the subsequent chain of events that we now know as the "Satyam Scandal".

I am sure this is purely coincidental, but it does offer the opportunity to reflect on some **key corporate governance considerations that should help buttress India's remarkable economic development and emergence as a global economic power.**

In his confession letter, Mr. Raju characterized his actions at Satyam as "riding a tiger, not knowing how to get off without being eaten." It is a powerful image: it captures the essence of unethical decisions and vividly points to the disturbing trends of repeated crises every few years in the first decade of the 21<sup>st</sup> Century.

Most of these crises, I might add, having taken place in the developed markets – the markets that have led the push for conformance to "internationally acceptable" standards of corporate governance. Emerging markets should draw little comfort from this in my view! But the image of the tiger also has a very positive connotation.

A recent front cover of the *Economist*—titled "How India's Growth will Outpace China's"—featured a blurred photo of a tiger running, seemingly dead-set on a target. No doubt, India's potential for long-term economic success. And, discussions this week with China's Premier and his delegation surely underscore this point.

It reinforces the image of India's prowess: an agile, focused, and strong economy racing at top speed. To maintain such momentum and live up to its forecast, India has a chance to establish a strong foundation of corporate governance in how its companies are run with stakeholders' best interests in mind. Points that were reportedly underscored yesterday by India's Prime Minister at the SCOPE Awards!

Crises such as Satyam compromise India's promising and enduring economic outlook. Because it exposes fundamental areas of concern that are important to foreign investors and capital markets. Issues such as:

- the relationship between controlling and minority shareholders particularly in family owned or controlled companies
- related party transactions and its proper regulation
- quality of financial disclosure
- the role of promoters
- independent oversight of the Indian accounting profession
- limited activism of domestic institutional investors, and
- issues of director independence and board effectiveness.

Observers of India's corporate governance acknowledge that reforms are taking place around these issues, but also lament the pace and commitment to change. Therefore, in the aftermath of the Satyam scandal it might be instructive to explore what the situation looks like two years later.

### ➤ **The larger picture beyond SATYAM...**

In this spirit, I want to focus on a few lessons that we should take from recent corporate and market crises and scandals. Where do they point to in terms of corporate governance priorities for India? In the time available, I can only focus on a few of these.

The critical issue, and one that possibly demands foremost priority, is the question of enforcement. This requires that there should be a speedy process of sanction and prosecution of corporate malfeasance and misdemeanor. This should be conducted objectively, with due and proper process in a manner that is consistent with the laws governing such conduct.

The issue is not so much that scandals take place - it is a function of free enterprise and business risk - but that very often through the process of prosecution we can learn about the events in a way that helps inform market and regulatory responses to address shortcomings or loopholes. For example, in the U.S., this led to the establishment of an independent oversight of the accounting profession - I will come back to this later.

It also provides certainty in the market that justice will be done, while signalling to companies and directors that their fiduciary and legal obligations are there to be fully observed for the benefit of a stable and vigorous economy. This lesson is aptly illustrated by other equally prominent cases that have followed the collapse of icon companies such as, for example HIH in Australia, Parmalat in Italy, and Enron in the United States.

The message that regulators need to deliver—for market reliability and market consistency that is central to capital formation—is quite simple: there are no exceptions when it comes to enforcing the full intent of existing laws and regulations. Enforcement is critical to the security sought by investors and by shareholders, especially knowing that their funds are safe and protected by a market provides the necessary mechanisms to actively secure their property rights.

In 2007, the OECD lauded Asian countries for substantially revamping its corporate governance frameworks, but warned that enforcement remained the most significant challenge and “the

unfinished agenda”!! CLSA and the Asian Corporate Governance Association echo this same conclusion in its *2010 Corporate Governance Watch* Report for Asia. A key observation is that “regulators make it too easy for companies to get away with box-ticking,” which keeps even the best Asian markets far from international best practice.

The key point I want to reiterate and re-emphasize is actually quite straight forward: rules and laws matter, but their enforcement is more critical and of greater importance to business sustainability, global competitiveness, entrepreneurial innovation, and economic progress.

It is of particular relevance to India’s projected future as a leading global economy. At the company level, this means that respect for laws by corporate boards must be beyond any measure of doubt and beyond the reach of any type of reproach. Boards must guard this reputation jealously. Nothing can be more damaging to business sustainability than the perception that laws and rules are things that are up for negotiation or can be readily arbitrated through inconsistencies in enforcement.

A culture of enforcement is paramount to credible and effective corporate governance frameworks but it is not the job of regulators alone! Boards, management, investors, the financial media and other key market players all have an important role to play in this process.

It seems here, from my own limited observations, that the continued fragmentation of India’s regulatory environment is a cause for concern – especially if one follows the somewhat curious events that followed SEBI’s attempts to investigate the Satyam case.

I might mention that regulatory arbitrage and the apparent weakening of the SEC capabilities in U.S. has had significant consequences for the global economy as we have witnessed with the recent financial crisis, let alone the United States economy itself! Equally, we only have to reflect on the impact this had on the Bombay Stock Exchange’s SENSEX Index at the time.



## **Capacity and skills to enforce regulatory regimes**

The issue of effective enforcement really centers at two integral levels:

The first is about enforcing the regulatory regime that is in place. It is about giving due process to the laws and regulations that are already on the books. But, in an effective and an informed way.

Which brings me to the 2nd level—and in my mind the most significant: that is, ensuring that regulatory agencies have the necessary skills and capacity to discharge their regulatory mandate.

The second level is perhaps among the most difficult challenges faced by emerging markets. It is a hurdle that holds back the progress of many countries.

Most CG assessments and reports repeatedly point to the first level—the lack of enforcement—as a major weakness, but rarely address dimensions of capacity or skills that account for enforcement weakness. To illustrate: A country very close to us was recognized for having a corporate

governance code that is on par with the best global standards. However, when I met with the Inspectorate of the Securities Commission, staff lacked a basic understanding of what constitutes corporate governance, which raises the obvious question of how they can be expected to enforce standards that challenge even the most sophisticated and experienced regulators.

As already indicated, the challenge of enforcement capacity and skills is equally problematic for advanced and mature markets. With the global financial crisis, we have witnessed the scope and consequences that can be unleashed by weakening regulatory capabilities.

It helps to quickly cite a few statistics to illustrate the magnitude of consequences stemming from regulatory lapses that exacerbated the global financial crisis. World Bank figures tell us that some 60 million more people have been trapped by poverty than would have happened without the economic downturn. Similarly, the Asian Development Bank estimates a loss of US\$50 trillion in the capital valuation of financial assets globally, equivalent to one year of world GDP.

And when it comes to jobs, the ILO reports that the global financial crisis has led to a sharp increase in unemployment in so-called advanced economies. The social disturbances, in consequence, continue to play out in some European countries. And, according to a senior Chinese official when countering discussions on the valuation of the Renminbi, expressed similar concerns for China's economy.

Therefore, the quality, consistency and effectiveness of enforcement should surely be a necessary condition for ensuring the extraordinary success of India's economy. Not just having the laws on the books, which arguably it has!

### ➤ **Other Salient CG Issues to Consider**

So what are some of the other more salient corporate governance issues coming out of the policy debates of the financial crisis and corporate scandals that are of relevance to the future of the brand "India, Inc"?

#### **Accounting Profession**

One issue that resonates well in India—and in fact is echoed across most countries—is the need for more independent oversight of the accounting profession. In making such a suggestion, by no means do I wish to imply that the accounting profession acts in an inappropriate fashion. Rather, it is to ensure that there is reasonable trust in the integrity of the regulation of the accounting profession and auditing standards and practices in India. And, also to avoid the obvious conflicts of interest that often come from the profession regulating itself. It is tantamount to being both judge and jury!

Satyam is a wake-up call to mandate rigorous accounting and auditing procedures, as well as disclosure requirements, to guard against fraud and divergence of company profits to promoters' bank accounts. It seems to me that the very real concerns around related parties transactions warrants particular attention!

This is something surely deserving of an increasingly advanced economy, especially as it now boasts some of the world's larger and more admired companies – if we only look at Infosys, Tata, WIPRO, today's awardees, among many others.

Tougher audit supervision and oversight emerge as top priorities, especially in the area of audit regulation. However, they must be determined by standards that meet India's requirements but having regard to international best practice.

### **Independent Directors**

There continues to be a lot attention focused on the issue of independent directors. Again, I want to caution against following a path of least resistance by assuming that increased requirements on numbers or qualifications of independent directors is a panacea for all manner of mischief!

The categorization is a structural issue, which the market artificially imposes in the absence of directors who are willing or even capable of fulfilling their fiduciary duties in a proper and effective manner.

The discussion that needs to carry more weight concerns the ability of any director to act not only with independent judgment, but with a level of competence appropriate to the position. To my mind, this is the bigger challenge that faces us all – director and board competencies.

Various remedies are being suggested around the world such as regular board and individual director evaluations. However, this assumes an already well functioning and suitably qualified board under the effective leadership of a board chairman well equipped to lead such a process.

This also presumes some measure of stronger regulatory oversight, especially in the banking sector with tighter “fit and proper” provisions. We need to be clear what we are asking regulators to regulate and market players such as institutional investors to monitor. The assessment undertaken by the regulatory authorities in the U.K. on the issue of board evaluations with the recent promulgation of the revised U.K. Corporate Governance Code was instructive and highlighted a significant gap between market expectations and regulatory capacity.

As we counter each crisis, there seems to be an increasing propensity to load more and more potentially complex provisions on the regulators. Current developments in the European Union strongly point in this direction.

I have some unconventional views on this, which time does not allow me to dwell upon, but I think we need to more carefully reflect on what we are trying to achieve and better understand why the market is not responding as we wish. I will come back to this point later in my talk!

As India's economic growth shifts from drivers of internal demand to an expansion into foreign markets, India's companies will need to become more open. It will mean permitting more foreigners to be intimately involved in decision-making, individuals with different cultures, and intellectual foundations that support India's business decisions and the country's ability to sustain its phenomenal economic growth.

I am happy to say that the Global Corporate Governance Forum, which I head, has forged a strong partnership with the National Institute of Securities Markets (NISM) and the Confederation of Indian Industry (CII) to build board directors' capacity, foster business-investor dialogue, and train the financial media - all of it aimed to support India's global economic expansion on a solid footing of good corporate governance best practices. This has been made possible with funding from the government of Japan.

The directors' training curriculum is based on the Forum's *Board Leadership Training Resources* and focuses on building directors' leadership skills and not focused solely on CG rules and compliance.

It is important to point out that the program has been tailored to the specific needs of the Indian market, meaning that the capacity for director training rests solely in the hands of Indian institutions. As with all our work globally, this is not exclusive to any single institution in a country, and thus ICSI and the Indian accounting profession have also participated.

Key to this all, is the need to focus on a higher level of director professionalism on Indian boards – which is not inconsistent with many other countries. I would commend to you the efforts in Brazil and the tremendous work put into this area to see the very evident benefits.

### **Institutional Investors**

We have seen a sharp focus on the role of institutional investors, given recent events in Europe and the U.S. This has culminated in the Stewardship Code in the U.K.

The success of corporate governance across most markets rests on the expectation that institutional investors will responsibly engage with companies in which they are invested. Engagement does not necessarily imply a confrontational approach or aggressive and negative posturing.

Quite the opposite! It is about exercising the rights and obligations that come with being a shareholder. It is the right to receive dividends, the right to receive information, the right to vote at meetings of the company ... and also, the obligation to exercise stewardship over the assets under their management. It is an obligation that is not sufficiently exercised in most emerging markets, let alone developed markets I might add as was highlighted only last week in a meeting involving the Global Corporate Governance Forum in Brussels.

However, the inherent conflicts facing fund managers' reluctant to take on powerful companies given the potential commercial consequences is one that requires further investigation.

Without a vibrant institutional investor community, companies are simply not going to take corporate governance very seriously – other than those that see the sense in it and are going to follow good CG practices regardless or find it imposed on them as they seek listings in foreign markets where the conditions may be more rigorous.

My observation has always been that India has a vibrant culture of discussion and debate, and so it surprises me that it seems absent in an important arena that would provide a certain measure of public assurance on market integrity and conduct.

The fall back position in the absence of effective self-governing mechanisms is too often, then, to call for more regulations and rules. I am not sure that is the solution either, unless you can finance huge capacity for regulatory supervision and enforcement which I very much doubt.

We have to be smarter in seeking solutions that do not endlessly impose greater and greater burdens on already stressed and under resourced regulatory capacity. We have to analyse market behaviours not just for the so-called “cost benefit” of regulatory impact as increasingly advocated in European markets, but need to carefully consider – if at all possible – the incentives that drive behaviour.

### **Incentives and Behavior**

A key lesson from the global financial crisis reveals that corporate governance principles for the most part remain valid and legitimate. Certainly boards were to blame, but as Jack Welch former head of GE said, don't put them at the top of the causes for the financial crisis as that would be giving them too much credit for a job they can't do.

This is a complex and, no doubt, potentially contentious area of discussion, which time does not allow me to dwell on in too much detail. It is about how people behave, how they react, and how they respond both to the spirit and to the letter of the law, and to the process of how these regulations are set and enforced.

If incentives are not aligned with expected behavior, it simply follows that the market players are not going to respond and contribute to the intended outcomes envisaged by regulators and policy makers. Certainly I am not suggesting that this is easy.

But if we believe the basis of India's success is the free enterprise, market system – then we have to look at what matters for “India, Inc.” As I have already mentioned, you have some regional and world leaders among your companies, a number of whom have sought to follow good CG practices to the extent it suits their strategic and operational imperatives.

What we should surely be seeking, is how this permeates across the Indian business sector as an unconditional criteria for doing business?

Not just among private sector businesses but also State-owned companies as highlighted by your PM yesterday.

➤ **Looking Forward.....**

To sum up, I have attempted to focus on a few critical issues in corporate governance as it might pertain to India, using the start of the Satyam collapse two years ago to evaluate the progress India has made.

Time does not allow a detailed analysis of each of these, nor a number of related matters such as executive compensation and other developments that have come to the fore globally over the past two years.

There is that terrific statement that some say came from the Batman movie, but others say it is from an old Chinese proverb, which goes something along the lines of “with power comes responsibility”. Given India’s historic corporate governance culture, many of us hope that as the balance of economic power gradually shifts to the rising emerging markets giants like India – that we will see India perhaps become a barometer of good CG in this new paradigm.

In my humble opinion, sound and good corporate governance practices are now intricately linked to India’s future as a leading global economy. Rules must be effectively enforced and they must be timely, consistent, predictable, transparent, non-politicized, and impartial to all market players. The aim must be to build on the strong brand many of India’s emerging corporate giants confer on India. Some of whom are here today to participate in the ICSI annual award for CG excellence!

At this point, it is appropriate for me to commend the ICSI for the work they have contributed to the progress of corporate governance in India. This annual award being only one such example of ICSI’s commendable contribution to advancing good CG practices in India.

The role of an effective and professionally qualified corporate secretary in the boardroom should not be underestimated! It is important that the regulators continue to give due recognition to this important function and, at least in my personal experience (to adapt an age old analogy that behind every successful man is a woman) – the same could be said of an effective board chairman with the support of a competent corporate secretary!!!

India is poised to be the next global economic power. It will no doubt forge its own course in terms of corporate conduct and integrity and its regulation, as it should. India has the potential to demonstrate the right way to do things. To demonstrate sustainability, consistency, reliability, and applicability of good corporate governance principles and standards.

With a sound and effective environment for corporate governance, no country or company should fear galloping atop a mighty and triumphantly determined tiger.

Finally, while I have the opportunity, let me congratulate those companies which will receive awards today for their CG. Thank you for your time and for listening to me!