

Revising Self Regulation as a Mode of Corporate Governance: Regulator as Promoter of Self Regulation

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It has long been believed that corporate self-regulation offers significant advantages for reducing unlawful or unethical corporate behavior over the alternative of increased direct governmental regulation of corporate activities. It is this point where corporate responsibility and governance intersect. The law is limited in its ability to regulate business behavior in situations where the cost of enforcing laws may be too great, or the enforcement of laws would require the violation of higher values in the society, or ethical standards or norms for behavior cannot be easily translated into objective, judiciable, legal standards.

Developing concept of Self regulation is a reflection of the global market which is going through transition. State is withdrawing from the market as a regulator, promoting deregulation and dissolving barriers. The limited jurisprudence of self regulation draws from the principle of positive and negative incentives as motivating factors. The objective of the article is to review the recommendations of the Cadbury committee and the J.J. Irani committee on self regulation in corporate governance and suggest a proposed model befitting the Indian scenario. Part I covers the existing jurisprudence of corporate governance in our country. Part II highlights self regulation as a mode of corporate governance. In light of inapt enforcement of regulations and existing working model of self regulation, the article in part III suggests the designing of a successful system where in the regulators promote self regulation thereby striking a balance between open market freedom and state intervention. The proposal has been justified in the context of the current Indian corporate sector so as to establish its relevance.

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I. Jurisprudence of Corporate Governance in India: Committee Recommendations on Corporate Code of Conduct

Corporate governance is a terminology that came in vogue with increased stakeholder awareness and changing market scenario. Corporate governance is the process by which corporations are made responsive to the rights and wishes of stakeholders.¹ The concept of Corporate Governance process may be helpful because it emphasizes the continually changing nature of expectations which boards have to meet, while the issue of who are the stakeholders and what are their rights is variable.

The basic governance issues are power and accountability. They involve where power lies in the corporate system and what degree of accountability there is for its existence. The balance of power within the corporate system is continually shifting and it is these changes especially in relation to shareholder owned companies which bring governance issues to the fore.

Currently in India corporate governance is ineffective. It remains more a concept on paper than in practice. This is not only due to poor enforceability but also inapt methods of governance. It came to the fore front after the Cadbury Committee made recommendations on corporate governance in the United Kingdom. This sparked debate on the value framework, the ethical framework and the moral framework under which business decisions are taken. In the Indian context, the need for corporate governance has been

¹ Demb and Neubauer, *The Corporate Bond: Confronting the Paradoxes Adrian Cadbury, Corporate Governance and Chairmanship A Personal View* (Oxford University Press, New Delhi, 1st ed, 2003)

highlighted because of the scams occurring frequently since the emergence of the concept of liberalization from 1991. We had the Harshad Mehta Scam, Ketan Parikh Scam, UTI Scam, Vanishing Company Scam, Bhansali Scam and so on. In the Indian corporate scene, there is a need to induct global standards so that at least while the scope for scams may still exist, it can be at least reduced to the minimum. The corporate governance code proposed by the Confederation of Indian Industry is modeled on the lines of the Cadbury Committee (Cadbury, 1992) in the United Kingdom.³ It recommended that boards of publicly-traded UK corporations include at least three outside directors and that the positions of the chairman of the board and chief executive officer not be held by a single individual. The underlying presumption was that these government-sponsored recommendations would lead to enhanced board oversight.⁴ In other words, it implied the separation of management from ownership.

In the backdrop of legislative and regulatory change brought about by the revised clause 49 of the Listing Agreement and the JJ.Irani Committee report on corporate governance what is lacking is a model that can be implemented. Clause 49 of the Listing agreement was modified post the Narayana Murthy Committee report which was set up by SEBI, under the chairmanship of Mr. N. R. Narayana Murthy, to review Clause 49, and suggested measures to improve corporate governance standards. Some of the

² <http://www.indiacorporateadvisor.com/docs/cgindia.asp>

³ *Ibid*

⁴ Jay Dahya, Nickolaos G. Travlos and John J. McConnell, *The Cadbury Committee, Corporate Performance and Top Management Turnover*, www.mgmt.purdue.edu/centers/ciber/publications/pdf799-004.pdf, <visited on March 12, 2009>

major recommendations of the committee primarily related to audit committees, audit reports, independent directors, related party transactions, risk management, directorships and director compensation, codes of conduct and financial disclosures.

J.J Irani Committee Report followed in line with the many guidelines that came earlier and recommended the amendment of the Companies Act. Broadly the objective of the review was to retain desirable features of the existing framework, segregate substantive law from the procedures to enable a clear framework for good corporate governance that addresses the concerns of all stakeholders equitably; revise the law so as to enable a compact statute that is amenable to easy understanding and interpretation.⁶ However, it was succinct in pointing out that legislative reform alone would not help our cause and it needs supplementation by regulatory and professional bodies whose role was left undefined. It mentioned in passing small industries and them deserving need for differential treatment and brushed through the issue of time limitations and subsequent need for more tribunals. The Committee pointed that the system of self regulation contemplated by the Companies Act in section 372 in relation to inter corporate investment is not effective and requires a system of check and balance to increase its viability.

Most Committees recommended only legislative and regulatory reform with little emphasis on self regulation as a tool of governance. The National

⁶ National Foundation for Corporate Governance, *Discussion Paper -Corporate Governance in India: Theory and Practice*, (NFCG, 2004)
Government of India, *Report: J.J Irani Committee on Company Law* (Ministry of Company Affairs, 2005)

Foundation on Corporate governance was of the opinion that mandatory legal sanctions should be minimal and voluntary compliance and self regulation should buttress the same.⁷ The recently proposed heightened degree of desired conduct by the Confederation of Indian Industry (CII) is mere guidelines which lack incentives for enforceability. Like the many other directives of corporate ethics and transparency they remain attractive in theory.

II. Self-Regulation as mode of corporate governance: Importance and Relevance

Developing a system of Self regulation is in the interest of a cost effective yet efficient supervision to. strengthen corporate governance with least interference from the government and regulators. In fact, apart from deviations now and then, the principles of self regulation have worked effectively especially in the securities markets in the past. *

The recent scams and scandals have emerged mostly because the corporate have managed to identify loopholes in the existing system and circumvented the compliance norms and enforcement of self regulatory mechanisms. Besides, adopting a well laid self regulatory mechanism would further eliminate delays due to routine and complicated procedures and the limitations of bureaucracy which the company officials and members may be subjected to.⁹

⁷Supra note 6

⁸ Sam S. Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 Wash. & Lee L. Rev. 853,; 856 (1985)

⁹ Jonathan R. Macey, *Options for Future Regulation of Financial Planners*, Part II, 15 J. Fin. Plan. 90 (2002).

With rapid globalisation and constantly changing economic environment, most of the government regulations face *the threat* of becoming outdated and irrelevant but cannot be repealed away without substantial time lag. Self-regulation is capable of meeting the requirements of flexibility.¹⁰

Besides, it is more convenient to seek compliance in case of rules framed for oneself in comparison to those imposed from the authorities. Self regulation would be more comprehensive and practically suited as per the needs of industry with regards to regulatory concerns." Not disregarding the importance of regulators like SEBI in the securities market and its reasonably well achieved objectives, it is also necessary to understand that proper implementation of regulatory control cannot come without an effective internalisation process which spreads within the corporate organisation becoming a part of its existing culture. The establishment of a regulator to be involved with all aspects of corporate behaviour would involve an enormous bureaucracy, it is necessary to design a legal framework which establishes a form of directed self-regulation within companies.¹²

The debate about the merits or demerits of self-regulation was given renewed impetus by the appearance of the Cadbury Report in 1992, but by 1995, evidence was beginning to emerge of significant levels of compliance with the Cadbury Code, albeit with lower levels among smaller companies.

¹⁰ Steven M. H. Wallman, *Competition, Innovation, and Regulation in the Securities Markets*, 53 Bus. Law. 341,356(1998) ¹ Ernest E. Badway and Jonathan M. Busch, *Ending Securities Industry Self-Regulation As We Know It*, 57 Rutgers L. Rev. 1351 (2005)

¹² *Ibid*

¹³ A. Belcher, *Regulation by the Market: The Case of the Cadbury Code and Compliance Statement*, J.B.L. 321 (1995)

Enforcement mechanisms, while not as final and crushing as legal enforcement, can nevertheless be very varied and create a supportive environment for a self-regulatory code.¹⁴

III. Enforcing Self Regulation: A proposed model

Self Regulation as a mode of governance is in its nascence in India. Most Committee reports that have opined on corporate code of conduct have suggested self regulation as the ideal mode of ensuring corporate governance given voluntariness and flexibility are its characteristic features. These are essential to ethical behavior considering companies are profit making enterprises. However principles like this are lofty and ideals like this lacking enforceability. Self Regulation is not a concept alien to India. It has been long contemplated by the market regulator SEBI, which has incorporated the power to formulate self regulatory organizations in section 11 (2) (d) of the SEBI Act, 1992. The power of these organizations is left to the discretion of the SEBI. Currently four such organizations exist in our country, all functioning with tremendous ease and success.¹⁵ These are Association of Merchant Bankers of India (AMBI), Association of Mutual Funds of India (AMFI), Association of Custodial Agencies of India (ACAI), Registrars Association of India (RAIN). Their role does not include corporate governance but they help meet objectives like investor protection, streamlining activities, facilitation of services etc.

What we propose is *directed self regulation*. This is a variant of the above concept of self regulation. Instead of each company setting its own

¹⁵Securities Exchange Board of India, *Annual Report* (SEBI, 1996-97)

standards of regulation, the standards or aim of the regulation is defined.¹⁶ It is a product of the newly developing 'deregulation' where in the state is attempting to withdraw as the direct agent of command and control and public management, in favour of being an indirect regulator of internal control systems in both public (or formerly public) and private agencies".¹⁷ Detailed implementation is left to individual companies so that the mechanisms which suit that company may be established. While directed self-regulation lacks the flexibility of avoiding over strict rules for small enterprises, it shares with enforced regulation the benefits of individual design of rules so that companies are likely to be more committed to them, hostility to outside regulators is avoided and the confusion of two rulebooks is avoided.¹⁸ Self regulation can thus be effective if pursued diligently through a system of incentives. The system has to be so designed that self regulation is imbedded and promoted.

The proposed Model has the following three essential features:

1. Industry guidelines on corporate conduct and mandatory adoption of a code of conduct by every company to work on principle peer pressure.
2. Negative and Positive Incentives to motivate compliance.
3. Self Regulatory Organizations to promote regulation.

A. Industrial Guidelines

The biggest drawback of the much discussed self regulation system is its inability to be enforced. A voluntary code to be subscribed to like this requires some incentive to make it adoptable. In the absence of such motive it

¹⁶ *Supra* note 12.

¹⁷ *Ibid*

¹⁸ Vanessa Finch, *Corporate Governance And Cadbury: Self-Regulation And Alternatives*, **J.B.L. 51(1994)**

remains a vague philosophical virtue. In order to make it a functional mechanism corporate governance certain factors can be used as tools to make weight? proposition of self regulation. The principle of mutual dependent symbiosis can be employed to meet these objectives. If the broad-guide under which such a code of corporate conduct is to be formulated is industry wise, entities like peer surveillance and good will can be used to pressure a company's compliance to the code. We suggest that each industry makes a personalized set of guidelines/ framework for companies to follow under it to devise and adopt a code for corporate conduct made by them within the ambit of the framework laid down by the industry. The formulation of an appropriate code will become industry subjective and good will amongst companies in the industry will serve as an incentive to comply with the adopted code. If a company fails to adopt they stand to lose the trust reposed in them by the other companies which is essential to a company which is in a symbiotic relation with other companies in the same industry. Thus, a code for corporate governance would be mandatory but it can be made by each company autonomously keeping its features and interests in mind. The code given by a company- gives to itself will require approval by the Self regulated organization to ensure governance is not reduced to a sham. At present, clause 49 of the listing agreement requires a quarterly compliance report to be under the supervision of compliance with the code of conduct. However the report is not accepted and there is no system to check its authenticity. The scheme of corporate governance in clause 49 is such that companies are placed under

¹⁹ Antonio Vives, *Corporate Social Responsibility: The Role Of Law And Markets*, 83 Kent L. Rev. 199(2008)

²⁰ Dilip Kumar Sen, *Clause 49 of the Listing Agreement* [www.icaai.org/resource_file/10980dec04p806-811 .pdf](http://www.icaai.org/resource_file/10980dec04p806-811.pdf), <visited on March 10, 2009>

surveillance of SEBI and the stock exchange making regulation dispersed and fragmented.

B. Incentives

No system is effective without an enforcement strategy and in the absence of one currently self regulation remains a philanthropic concept. Enabling regimes can encourage compliance in the long term through incentives. They can be positive and negative. This serves as a motivating factor to attract compliance. As more and more firms adopt corporate governance practices, over time these voluntary practices can become the norm among a majority of firms. In year one of its inception, relatively few firms may comply with a voluntary code. Over time more and more firms may comply, believing that they will lose investors or be outdone by their competitors (because of "peer pressure") if they do not. This peer pressure effect is a pure market mechanism that can occur without mandatory legal rules.²¹ This is an instance of negative incentive. Legal sanction constitutes another example of negative incentive. Examples of Positive incentives include rewards for compliance and awards as gestures of encouragement. The ICSI National Award in place for excellence in corporate governance is one such positive incentive.

To bring the element of effective implementation we suggest the doctrine of absolute liability be imported to violations of the code for corporate conduct. The doctrine translates to no defense being available for

²¹ Anita Indira Anand, *An Analysis Of Enabling Vs. Mandatory Corporate Governance: Structures Post-Sarbanes-Oxley* 31 Del. J. Corp. L. 229 (2006)

breach of a duty of care. To justify the use of this doctrine two points need to be looked into :

- 1) Gravity of consequences of breach
- 2) Need of compensation

The doctrine is now in use in environmental jurisprudence²⁴ in India. The only rationale for its adoption was that environmental hazards have a long lasting effect and liability can be easily escaped using intervening factors as defense. In light of the above it became difficult to accord liability and hence fix a source for compensation which is indispensable in the ends of justice. Similarly, corporate conduct is a loose framework, vague and subjective. It is very easy to escape liability using lacuna in the law. The effect of a slip in compliance is dire as a lot of public money is at stake. As investor trust is shaken, the securities market is gravely affected. Both requirements of absolute liability are thus met and its use justified in this case.

For increasing legal and self governance reasons, voluntary disclosure of corporate affairs would strengthen the system of self regulation. In many American corporations, internal investigations are continuously being undertaken by corporate executives as an essential part of responsible self-governance. The federal agencies in US have created additional incentives to conduct internal investigations by encouraging voluntary disclosures of

²² Maragaret R. Brazier, *Clerk andLindsell on Torts* (Sweet & Maxwell, London, 14th e.d.)

²³Murphy and Burgess, *NSW Legislation Review Committee Inquiry into Strict and Absolute Liability*, www.nswccl.org.au/docs/pdf7StrictLiability.pdf, visited on March 11, 2009 ²⁴*Vellore Citizen Welfare Forum v. Union of India* AIR 1996 SC 2715

wrongdoing by corporations.²⁵ The Securities Exchange Commission offers Formal voluntary disclosure programs encouraging corporations to investigate non-compliance and report the results to the Securities Exchange Commission by recognising the mitigating effect of such disclosures on the ultimate penalty.²⁶

Taking a cue from the voluntary disclosure schemes under the Securities Exchange Commission in United States, positive incentive of self regulation can be determined. If the companies adopting the codes of conduct containing self prescribed rules and regulations happen to not comply with them due to negligence of any member of the company; the company should voluntarily report this non-compliance within a period of one year to SEBI (the degree of reduction of penalty would be dependent on the promptness of the disclosure, sooner the non-compliance is reported the lesser the penalty). Besides, such disclosure would be kept confidential as between SEBI and the company. Thus, the voluntary disclosure of non-compliance would benefit the company (any company defaulting its own code) in terms of reduction of penalty and no criminal prosecution against the directors and members not directly involved in the violation.

C. Self Regulatory Organisations

Since we propose the market regulator as a promoter of self regulation we have designed their role as supervisory to that of a self regulatory

~ **Richard H. Porte**, *Voluntary Disclosures To Federal Agencies—Their Impact On The Ability Of Corporations To Protect From Discovery Materials Developed During The Course Of Internal Investigations*, 39 Cath. U. L. Rev. 1007 (1996) *" Janet Dine, *Discovery of Internal Corporate Investigations*, 32 Stan. L. Rev. 1163 (1980)

organization. In 2004, SEBI issued the Self Regulatory Organization Regulations providing for formation recognition and functioning of voluntarily formed self regulatory organizations. These are non profit companies under Section 25 of the Companies Act. Regulation 22 provides that the SEBI may direct self regulatory organizations to take disciplinary action against the delinquent members including expulsion suspension or a penalty of like nature not involving the levy of monetary penalty. SEBI is also endowed with the power to withdraw the recognition of self regulator organizations in the interest of trade and the public. This means that self regulatory organizations function under board supervision²⁷ and divide the burden on the SEBI. Although regulation 14 provides a loose framework as to the possible role of self regulatory organizations, it still retains discretionary power of the board to alter or expand the same through directions under regulation 14(1). If corporate governance is included in their scope of functions these organizations can prove effective to ensure compliance with self regulatory codes of conduct by monitoring companies within an industry. Currently self regulatory organizations are voluntarily formed and are subsequently recognized by the SEBI. This norm needs to be altered to compulsory formation of self regulatory organizations industry wise to give due effect to the code for corporate conduct which can be done by a mere SEBI notification and requires no legislative amendment. SROs can be made better functional and efficient under the regime of *directed self regulation* as proposed above. It would eliminate the drawback of unenforceability at voluntary formation of SROs by giving them wider powers including enforceability under Regulation 14 (1).

The board of self regulatory organizations would comprise of SEBI nominees, brokers and independent members. They would function to conduct random checks on about 10-15 (number to be fixed as per industry size) companies in their industry area to ensure compliance of the company with its adopted code of conduct. A report on their conducted investigation would be then submitted to the SEBI who can investigate further in case needed under -its investigatory powers enshrined in the SEBI Act, 1992. The nature of Self regulatory organizations will thus be administrative and regulatory only. The proposition is that they will possess no adjudicatory powers as delegation of adjudicatory powers by SEBI is *ultra vires* its powers.

IV. Conclusion

The recurrent securities market scams and corporate frauds across the globe have time and again questioned the prevailing corporate governance standards, if not the efficiency of the market regulator. Indeed, the practical possibility of such incidences cannot be completely eliminated by any system of governance as such idealism does not exist. However, the extent of the consequences, the impact on economy and markets and the gravity of non-compliance compel us to seek better and more effective means of enforcing corporate governance norms.

The proposed model may face certain operational limitations which can be overcome by making minor modifications and adaptations. It is merely a step ahead of the long prescribed remedy in the form of self regulation by several committees; in as much as it aims to broadly lay down an effective enforcement mechanism for self governance. Without any direction as to the

enforcement of such a system, self regulation cannot gain popularity and wider following.

As elaborated above, self regulation can provide a path breaking success in the enforceability of corporate governance and achieve far greater compliance, if not absolute compliance. The proposed model of *directed self regulation* as opposed to the De regulation/self regulation models in place, is suited well for the present economic and market scenario as it charts out well defined roles at different levels for corporate governance, namely - the individual company level, the industry level and the market regulator's level. The role of the company is to provide for applicability of self adopted governance rules. The role of the industry self regulator is to set standards for the industry participants for self governance. Finally, SEBI's role is given as the supervisor and enforcer of these regulations.