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MAINSTREAMING ESG AND ROLE OF THE BOARD

Dr. Niraj Gupta & Amar Chanchal [*]

ABSTRACT

*Societal challenges like widespread poverty, inequality, climate and risks posed by threats like the ongoing COVID-19 pandemic, has forced us to revisit the traditional models of conducting business. Environmental, Social and Governance ("**ESG**") framework for decision making and reporting by businesses is one such approach that looks beyond profits and shareholders to create value for other stakeholders. It covers a range of non-financial issues which are now considered critical, especially by the investors while making their investment decisions. The current ESG paradigm is the culmination of different movements in the history focusing on different aspects of Corporate Governance. Though the role of regulatory framework, institutional investors and other external drivers plays a major role in imbibing ESG into the functioning of business in any jurisdiction, the real push can come only from the internal drivers which include the leadership (board of directors, KMPs) and the culture in the organization. The regulatory framework in India has also responded to the need of ESG adoption by introducing Business Responsibility and Sustainability Reporting ("**BRSR**") for top 1000 companies. The paper has presented an overview of the evolution of ESG and the regulatory framework in India and the role of boards in ESG integration.*

Keywords: Corporate Governance, Sustainability, ESG, BRSR, non-financial reporting.

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I. BACKGROUND

Environmental, Social and Governance ("**ESG**") norms are a set of standards for a company's operations that are being largely looked into by various stakeholders to ascertain sustainable business practices. It is a review of the social, economic and environmental impact of everyday business operations of the company. Apart from looking at the conventional financial indicators, the focus has now shifted towards how a company contributes to various environmental issues, manage its relationships with the communities and various stakeholders and adhere to various business standards in its operations. ESG has emerged as one of the top themes of discussion in the board rooms.[1,2] The concept of ESG has evolved over the years with the evolution of corporations and various aspects of their governance.

The concept of corporate governance is as old as the corporations themselves and can be traced back to the era of the 16th and 17th centuries when major chartered companies like East India Company, Hudson's Bay Company, Levant Company etc., came into existence. However, the term 'corporate governance' came to the fore only in the 1970s in the US and is largely used to define the functioning and balance of power between the board, executives and shareholders.[3] It also includes the pattern of relationship with employees, customers, communities and other stakeholders to form the strategy of the company. This has been defined as the behavioural side of corporate governance. The normative side of

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[1] Kristen Sullivan et al., *The Role of the Board in Overseeing ESG: Projections on Emerging Board Matters,* GOVERNANCE OUTLOOK FOR NAT'L ASS'N CORP. DIRECTORS (2022).

[2] Jeff Swinoga & Thibaut Millet, *Why ESG is climbing the boardroom agenda,* GOLDHUB INSIGHTS (Jan. 23, 2020), https://www.gold.org/goldhub/gold-focus/2020/01/why-esg-climbing-boardroom-agenda.

[3] Brian R. Cheffins, The History of Corporate Governance (U. Cambridge & ECGI Working Paper Series in L., Working paper no. 184, 2012), http://ssrn.com/abstract=1975404 [hereinafter, BR Cheffins].

corporate governance includes a set of rules that may include various corporate laws, securities regulation, disclosures, listing requirements, self-regulatory mechanisms etc.[4]

A. WAVE ONE: GOVERNANCE IN FOCUS

After World War II, corporations in the US grew rapidly and in this era of corporate prosperity, internal governance of the companies was not a top priority. It was only in the 1970s when certain companies were found making illicit payments to foreign officials, the federal Securities and Exchange Commission ("**SEC**") brought corporate governance into the official reform agenda.[5] The concept became a hot topic among academicians, practitioners and policymakers and there were numerous other developments that took place during this time. In 1978, the Business Roundtable, a group established in 1974 to represent the views of CEOs of major corporations, issued a statement on "The Role and Composition of Directors of the Large Publicly Owned Corporation" focusing on independence of the board and transparency in decision making. After a prolonged debate and deliberations, The American Law Institute ("**ALI**") published *Principles of Corporate Governance: Analysis and Recommendations* in 1992. The attention started shifting outside the US in the 1990s as US companies started getting competition from Japanese and German companies. This led to the comparison of corporate governance systems across the countries. This was also the time when Britain included corporate governance in its agenda, and in 1991 set up the Committee on the Financial Aspects of Corporate Governance under the Chairmanship of Sir Adrian Cadbury (known as the Cadbury Committee). The Committee developed a 'code of best practice' and recommended guidelines to improve corporate governance. The Cadbury Code served as a model for other countries to develop their own corporate governance code. The demand for a strong

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[4] Stiplon Nestor, *International Efforts to Improve Corporate Governance: Why and How*, OECD (2001), https://www.oecd.org/corporate/ca/corporategovernanceprinciples/1932028.pdf.
[5] BR Cheffins, *supra* note 3.

corporate governance structure was also backed by various instances of corporate governance controversies across the globe.[6]

OECD set up a task force on corporate governance in 1998 and after its recommendations; the OECD Principles of Corporate Governance were adopted in 1999. The last revision of the principles was undertaken in 2015.[7]

In India, the focus on corporate governance gained momentum after the opening up of the economy for the private players in the 1990s. The first major institutional initiative towards corporate governance was taken by the Confederation of Indian Industry ("**CII**") in 1996 with an aim to develop a code for the companies. There were numerous initiatives by the Ministry of Corporate Affairs and SEBI to bring corporate governance in the country at par with international standards; setting up of Kumar Mangalam Birla Committee (2000), Naresh Chandra Committee (2002), Narayana Murthy Committee (2003) with the mandate to improve corporate governance in the country are few examples.

Hence 'Governance' was the first broad pillar of ESG to evolve, get consolidated with uniformity in standards across the globe. However, the regulatory frameworks that include various principles, rules, laws and guidelines, would need continuous revision to address various emerging issues in this domain.

B. WAVE TWO: SHIFT OF FOCUS ON SOCIAL RESPONSIBILITY AND STAKEHOLDER ENGAGEMENT

The modern concept of social responsibility started emerging in the 1950s and 1960s. The earliest definition of corporate social responsibility came from Bowen in 1953, who defined it as "the obligations of businessmen to pursue those policies, to make those decisions, or to follow those lines of action which are desirable in terms of the objectives and

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[6] *Id.*

[7] OECD, G20/OECD Principles of Corporate Governance, OECD Publishing (Paris 2015) http://dx.doi.org/10.1787/9789264236882-en.

values of our society."[8] In subsequent years, other researchers kept raising their concerns on corporate behaviour towards various societal issues of the time. On the regulatory front, USA made some major advances in the 1970s that includes the creation of the Environmental Protection Agency ("**EPA**"), the Consumer Product Safety Commission ("**CPSC**"), the Equal Employment Opportunity Commission ("**EEOC**") and the Occupational Safety and Health Administration ("**OSHA**"). The publication of *A New Rationale for Corporate Social Policy* by the Committee for Economic Development ("**CED**"), USA, in 1971 pointed towards a broader role of business in society. The first cohesive definition of Corporate Social Responsibility was proposed by Carroll in 1979, according to which "the social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point in time"[9]. There was a growing concern towards the environment in the 1980s and 1990s and a number of international bodies were established (see next section on environment), showing the heightened concern towards sustainable development and indirectly pointing towards corporate behaviour.[10]

The institutionalization of CSR gained traction after the famous speech of the Secretary-General of the United Nations, Kofi Annan in 1999, exhorting business leaders to 'give human face to global market'. This led to the formation of the United Nations Global Compact ("**UNGC**") in 2000, which was a call to the companies to align their strategies and operation with universal principles on human rights and work towards societal goals. The ten principles of UNGC brought global attention towards corporate responsibility. The European approach to CSR was

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[8] Doug Caulkins, *President Howard Bowens & Corporate Social Responsibility*, GRINELL C. NEWSL. (Dec. 20, 2013), https://www.grinnell.edu/news/president-howard-bowen-corporate-social-responsibility#:~:text=By%20social%20responsibility%20of%20businessmen,and%20values%20of%20our%20society.%E2%80%9D.

[9] Archie B Carroll, *Carroll's pyramid of CSR: taking another look*, 1 INT'L J. CORP. SOC. RESP. 3 (2016), https://doi.org/10.1186/s40991-016-0004-6.

[10] MA Latapi Agudelo et al., *A literature review of the history and evolution of corporate social responsibility*, 4 INT'L J. CORP. SOC. RESP. 1 (2019).

presented in 2001 in the Green Paper '*Promoting a European framework for Corporate Social Responsibility*'. This was followed by a series of other initiatives by the EU to further strengthen the CSR ecosystem.[11]

The last decade has seen various jurisdictions formulating explicit CSR laws, which were till now assumed as voluntary initiatives. For example, corporate laws in the UK, China and Indonesia have made explicit provisions in their legislation for companies to undertake social responsibilities.[12] India has gone a step further and has made it mandatory for certain companies to spend 2 percent of their annual profits on CSR activities specified by the Companies Act, 2013.

C. WAVE THREE: BRINGING SUSTAINABILITY AND ENVIRONMENT IN FOCUS

The industrial development over the years has impacted the environment and led to serious problems like increased pollution, depletion of natural resources, loss of biodiversity and climate change, which in return have now started affecting businesses as well. As a result, the focus on corporate sustainability has gained momentum in recent times.

Historically, the industrialized countries (USA, Canada, Australia, Japan), in the 1970s and 1980s adopted Environmental Impact Assessment ("**EIA**") for various projects. The tool became a part of policy recommendations of key bodies like OECD (1979), UNEP (1987), World Bank (1989).

The Chernobyl nuclear disaster in 1986 was one of the first major events that brought focus on the role of business in environmental degradation. This was followed by the publication of the Brundtland Commission report titled *Our Common Future* (1987), which defined

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[11] *Id.*

[12] Li-Wen Lin, *Mandatory Corporate Social Responsibility Legislation around the World: Emergent Varieties and National Experiences,* OXFORD BUSINESS LAW BLOG (Nov. 18, 2020), https://www.law.ox.ac.uk/business-law-blog/blog/2020/11/mandatory-corporate-social-responsibility-legislation-around-world.

sustainable development for the first time as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs". The creation of the Intergovernmental Panel on Climate Change ("**IPCC**") (1988), Rio Earth Summit and United Nations Framework Convention on Climate Change ("**UNFCCC**") (1992), adoption of the Kyoto Protocol (1997) were some of the key developments that institutionalized the issue of environment and climate change and businesses' focus on the planet.

D. CONVERGENCE: CONNECTING THE DOTS AND EVOLUTION OF ESG

And finally, we witnessed the consolidation of the three – environmental, social and governance and constructive interference of the waves that have impacted the theory and practice of corporate governance across the globe. The theory of Triple Bottom Line ("**TBL**") which came in 1994, emphasized that companies should focus as much on social and environmental concerns as they do on profits. In 2004, the concept of ESG emerged when the UN Secretary-General Kofi Annan invited CEOs of major global financial institutions under the auspices of the UN Global Compact. The aim of this meeting was to integrate environmental, social and corporate governance philosophies into capital markets. The term ESG was coined a year later in 2005 in the conference report of this group titled 'Who Cares Wins'. Hence, the ESG agenda is largely driven by major global investors. They are using the ESG performance of the companies, assessed through various non-financial metrics, to make their investment decisions.

II. EMPIRICAL ANALYSIS OF CORPORATE GOVERNANCE, ESG AND BUSINESS PERFORMANCE

Studies have shown that corporate governance has a significant relationship with the financial performance of the companies and their market valuation. Gompers, Ishii and Metrick (2003) constructed a firm-level governance index ("**GIM Index**") for US-listed companies based on

24 governance provisions.[13] The study shows that companies with poor governance index scores had significantly lower valuations. These findings were further corroborated by another study by Bebchuk, Cohen and Ferrell (2004)[14] and Bhagat and Bolton (2008).[15] Similar results were also reported in the findings based on other jurisdictions; Bauer et al. (2004[16], 2008[17]) show that improved governance provisions on financial disclosure, shareholder rights, and remuneration have a positive impact on the stock price performance of European and Japanese companies, Kyere and Ausloos (2020),[18] in their study on listed UK firms shows that choosing right corporate governance mechanism can improve the finances of the companies and; Goel (2018)[19] shows improved financial performance of Indian companies in the initial phase of corporate governance reforms. Caixe and Krauter (2014),[20] found that the adoption of good corporate governance practices positively influenced the market value of Brazilian firms.

Studies have also shown that there is a significant relationship between corporate governance and risk management in companies (Tara and Sadri,

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[13] Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 (1) Q. J. ECON., 107 (2003), https://ssrn.com/abstract=278920.
[14] Lucian A. Bebchuk et al., *What Matters in Corporate Governance?* 22 (2) REV. FIN. STUD., 783 (2009), https://ssrn.com/abstract=593423.
[15] Sanjai Bhagat & Brian Bolton, *Corporate governance and firm performance*, 14 J. CORP. FIN., 257 (2008).
[16] Rob Bauer et al., *Empirical evidence on corporate governance in Europe: The effect on stock returns, firm value and performance.*, 5 J. ASSET MGMT. 91 (2004).
[17] *Id.*
[18] Martin Kyere & Marcel Ausloos, *Corporate governance and firms' financial performance in the United Kingdom*, 26(2) INT'L J. FIN. & ECON. 1871 (2020); https://doi.org/10.1002/ijfe.1883.
[19] Puneeta Goel, *Implications of corporate governance on financial performance: an analytical review of governance and social reporting reforms in India*, 3 ASIAN J. SUSTAINABILITY & SOC. RESP. 4 (2018); https://doi.org/10.1186/s41180-018-0020-4.
[20] Daniel Ferreira Caixe & Elizabeth Krauter, *The Relation between corporate governance and market value: mitigating endogeneity Problems*, 11(1) BRAZILIAN BUS. REV., 90 (2014); https://doi.org/10.15728/bbr.2014.11.1.5.

2015[21], Gennaro and Michelle 2021[22]). Corporate scandals around the globe are largely attributed to poor corporate governance practices. The global financial crisis of 2008 is also a major example of poor corporate governance leading to failure in risk assessment by major financial institutions (UNCTAD, 2010[23]). Corporate governance is a major tool that can be used by companies for better risk management.

Corporate governance is also instrumental in building a positive reputation of the company among various stakeholders which gives a sustainable competitive advantage in terms of attracting and retaining good employees, customer loyalty, attracting investments etc. leading to improved business performance (Ljubojevic´ and Ljubojevic´ 2008[24], Widerman and Buxel 2005[25]).

The existence of a company is defined by its purpose; the ultimate goal of the business, the essential reason why it exists, and how it contributes to the common good (Joly 2021).[26] Mayer (2021) [27] states that companies need to redefine profits in today's world when they are more than ever dependent and also making an impact on intangible, human, natural and social assets along with physical and material assets. As a result, corporate governance

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[21] Sharukh Tara & Sorab Sadri, "*Corporate Governance and Risk Management: An Indian Perspective*, 1(9) INT'L J. MGMT. SCI. & BUS. ADMIN., 33 (2015).

[22] Alessandro Gennaro & Michelle Nietlispach, *Corporate Governance and Risk Management: Lessons (Not) Learnt from the Financial Crisis*, 4 J. RISK & FIN MGMT., 419 (2021); https://doi.org/10.3390/ jrfm14090419.

[23] U.N. Conference on Trade and Development, *Corporate Governance in the Wake of the Financial Crisis: Selected International Views*, U.N. Doc. UNCTAD/DIAE/ED/2010/2 (Oct. 2010), https://unctad.org/system/files/official-document/diaeed20102_en.pdf.

[24] Cedomir & Gordana Ljubojevic´, *Building Corporate Reputation through Corporate Governance*, 3 MANAGEMENT (BOSN. & HERZ.) 221 (2008), https://www.fm-kp.si/zalozba/ISSN/1854-4231/3_221-233.pdf.

[25] Klaus-Peter Wiederman & Holger Buxel, *Corporate reputation management in Germany: Results of an empirical study*, 8(2) CORP. REPUTATION REV. 145 (2005).

[26] Hubert Joly, *Creating a Meaningful Corporate Purpose*, HARV. BUS. REV. BLOG (Oct. 28, 2021), https://hbr.org/2021/10/creating-a-meaningful-corporate-purpose.

[27] Colin Mayer, The Governance of Corporate Purpose, (Eur. Corp. Governance Inst. (ECGI), Working Paper No. 609, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3928613.

has started shifting focus from shareholders to stakeholders; that include interests of employees, customers, suppliers, communities etc. for long term value creation (Price 2019[28], Bottenberg et al. 2016[29]).

The shift towards stakeholders led to the development of non-financial parameters, metrics and frameworks to capture the performance of companies in these areas. This resulted in the development of non-financial reporting, which has gained prominence in recent years. Europe has taken lead with its Non-Financial Reporting Directive and its 2018 Action Plan on Financing Sustainable Growth. Several reporting standards and frameworks have emerged to help companies report on sustainability and other non-financial themes; Global Reporting Initiative ("**GRI**"), International Integrated Reporting Council ("**IIRC**"), Sustainability Accounting Standards Board ("**SASB**"), The Task Force on Climate-related Financial Disclosures ("**TCFD**"), The Carbon Disclosure Project ("**CDP**").[30] At this stage when non-financial reporting is still voluntary in most jurisdictions and reporting structures are still under development, sound corporate governance practices in the companies will ensure the quality of non-financial reporting, which can be further used in shaping sustainable business strategies.

The impact of climate change on business has received increased attention in recent years. This has been brought into focus largely by the report of the Intergovernmental Panel on Climate Change ("**IPCC**") on global warming, the Paris Agreement and recommendations of the Task Force on Climate-Related Financial Disclosures ("**TCFD**") set up by the Financial Stability Board. In their study on US companies, Aggarwal and

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[28] Konstantin Bottenberg et al., *Corporate Governance Between Shareholder and Stakeholder Orientation: Lessons from Germany,* 26(2) J. MGMT. INQUIRY, 165 (2017).

[29] Nicholas J Price, *The Stakeholder Model of Corporate Governance*, DILIGENT CORP. INSIGHTS (Nov. 8, 2019) https://www.diligent.com/insights/shareholder-engagement/stakeholder-model-corporate-governance/.

[30] PUBLIC POLICY, GLOBAL REPORTING INITIATIVE, https://www.globalreporting.org/public-policy-partnerships/the-reporting-landscape/ (last visited May 13, 2022).

Dow (2011)[31] show the significant impact of corporate governance on corporate actions to mitigate adverse climate change and environmental impacts. The findings show that despite regulatory ambiguity, the market is penalizing large emitters, while at the same time rewarding firms for their mitigation efforts. Firms across the jurisdictions are facing pressure from various stakeholders; regulators, investors, NGOs, consumers and many have adopted various sustainable practices to bring down their emissions (Sullivan and Gouldson, 2017[32]).

Nowadays non-financial reporting is synonymous with reporting on ESG issues identified by the business and adopted in its operations. There are various studies that have shown a positive relationship between ESG adoption and corporate financial performance.[33] A meta-analysis carried out for more than 2000 empirical studies finds a strong relationship between ESG and corporate financial performance ("**CFP**") over time (Friede et al., 2015[34]). The findings are further substantiated by studies based on specific jurisdictions (Santis et al., 2016[35], Velte, 2017[36], Matos., 2020[37]). These findings make a strong economic case for the adoption of ESG into business operations.

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[31] Raj Aggarwal & Sandra Dow, *Corporate governance and business strategies for climate change and environmental mitigation*, 18(3-4) THE EUROPEAN J. FIN 311 (2012).
[32] Rory Sullivan & Andy Gouldson, *The Governance of Corporate Responses to Climate Change: An International Comparison*, 26(4) BUS. STRATEGY & ENV'T, 413 (2016).
[33] Witold Henisz et al., *Five ways that ESG creates value: Getting your ESG Propositions right links to higher valuation,* 2019 (4) MCKINSEY Q. (2019).
[34] Gunnar Friede et al., *ESG and financial performance: Aggregated evidence from more than 2000 empirical studies*, 5 J. SUSTAINABLE FIN & INV., 210 (2015).
[35] Paula Santis et al., *Do sustainable companies have a better financial performance? A study on Brazilian public companies*, 133 J. CLEANER PROD., 735 (2016).
[36] Patrick Velte, *Does ESG performance have an impact on financial performance? Evidence from Germany*, 8(2) J. GLOBAL RESP., 169 (2017).
[37] Pedro Matos, *ESG and Responsible Institutional Investing Around the World: A Critical Review,* CFA Institute Research Foundation Literature Reviews (2020), https://ssrn.com/abstract=3668998.

III. CONCEPTUAL UNDERPINNINGS

A. ROLE OF DIRECTORS IN THE REGULATORY FRAMEWORK

The role of directors in the boards has enhanced over time. In the case of India, the laws and rules have been revised and the role of directors has formed part of the evolving regulations in a more explicit manner.

1. Companies Act 2013:

The Companies Act 2013 makes it mandatory for every company to have a Board of Directors with specified composition. The Act also recognizes the concept of Independent Director which was earlier included only in the listing agreement, to bring more transparency into the board functioning. **Schedule IV** of the Act contains Code for Independent Directors which includes guidelines for professional conduct, provisions on role, duties, appointment, re-appointment, removal and evaluation of independent directors. One of the key roles of independent directors is to safeguard the interests of all stakeholders, particularly the minority shareholders. **Section 166** of the Act defines the duties and responsibilities of the directors which explicitly states that they must act in good faith and in a diligent manner to promote the objects of the company.[38] Mainstreaming ESG and the legal obligations of the directors are intertwined as professionals and experts are of the opinion that adopting measures on various ESG issues builds a strong brand image and creates long term value for the business (Forbes[39], McKinsey[40]). The Act also provides for penalties if the directors fail to discharge their duties as per the provisions. They are expected to keep the interest of the company and the shareholders ahead of their personal interests.

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[38] Companies Act, No. 18 of 2013, §166 (India).

[39] Bo Bothe, *Building Brand Integrity through ESG Reporing*, FORBES (Aug. 28, 2020) https://www.forbes.com/sites/forbesagencycouncil/2020/08/28/building-brand-integrity-through-esg-reporting/?sh=63c048e85369.

[40] Witold Henisz, et al., *Five ways that ESG creates value*, 2019 (4) MCKINSEY Q. (2019), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value.

2. SEBI LODR:

Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**SEBI LODR**") also contains various provisions on responsibilities of directors of listed companies. The Regulations require all the Board members to act transparently and disclose all material information that can affect the listed entity. The Board of Directors are responsible to ensure high standards of corporate governance in the company and making necessary changes as needed. They must ensure that an appropriate system is in place for risk management and compliance with the law and various standards.[41]

There are various other laws and rules that cover various aspects of ESG but the provisions under the Companies Act 2013 and the SEBI LODR are the principal sources that explicitly lists the duties and responsibilities of directors, both individually and as part of the Board as a whole, to ensure that the decision-making process should keep in mind the long-term interest of the company and its stakeholders.

B. EVOLVING FRAMEWORKS AND STANDARDS PUSHING ESG AGENDA

The regulatory framework for responsible business in the country is shaped largely by the various legislations, guidelines and rules framed by the Ministry of Corporate Affairs and SEBI, the regulatory body for securities and commodity markets in India.

1. Corporate Social Responsibility Voluntary Guidelines, 2009

Though several laws, at Union and State, were formulated at different times covering various non-financial aspects of business, a more comprehensive approach to responsible business behaviour was first taken in 2009 when the Ministry of Corporate Affairs announced **Corporate**

[41] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Fourth Amendment) Regulations, 2019, Gazette of India, pt. III, sec. 4 (July 29, 2019).

Social Responsibility Voluntary Guidelines. As the name suggests, these were voluntary and non-prescriptive in nature and encouraged businesses to develop a formal CSR policy with some core elements to fulfil society's expectations. As per the guidelines, the core elements of the CSR policy should include: 1. Care for all Stakeholders 2. Ethical functioning 3. Respect for Workers' Rights and Welfare 4. Respect for Human Rights 5. Respect for Environment 6. Activities for Social and Inclusive Development.[42]

2. **National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Businesses (NVGs), 2011**

Building on the CSR voluntary guidelines and further increasing the scope of responsible business behaviour, the Ministry of Corporate Affairs announced the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Businesses ("**NVGs**") in 2011. The NVGs 9 principles state that Businesses should: 1. conduct and govern themselves with ethics, transparency and accountability. 2. provide goods and services that are safe and contribute to sustainability throughout their life cycle. 3. promote the wellbeing of all employees. 4. respect the interests of, and be responsive towards all stakeholders, especially those who are disadvantaged, vulnerable and marginalized. 5. respect and promote human rights 6. respect, protect, and make efforts to restore the environment 7. when engaged in influencing public and regulatory policy, should do so in a responsible manner. 8. support inclusive growth and equitable development. 9. engage with and provide value to their customers and consumers in a responsible manner.[43]

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[42] MINISTRY CORP. AFF., GOV'T OF INDIA, CORPORATE SOCIAL RESPONSIBILITY VOLUNTARY GUIDELINES (2009), https://www.mca.gov.in/Ministry/latestnews/CSR_Voluntary_Guidelines_24dec2009.pdf.

[43] MINISTRY CORP. AFF., GOV'T OF INDIA, NATIONAL VOLUNTARY GUIDELINES ON SOCIAL, ENVIRONMENTAL & ECONOMIC RESPONSIBILITIES OF BUSINESS (2011), https://www.mca.gov.in/Ministry/latestnews/National_Voluntary_Guidelines_2011_12jul2011.pdf.

3. Business Responsibility Reports (BRR), 2011

Both CSR guidelines and NVGs were voluntary in nature, but played an important part in preparing businesses in terms of society's expectations from them and also what they can expect from the regulatory mechanism going further. SEBI issued a circular in 2011 making companies disclose their performance on the NVG principles through **Business Responsibility Reports** ("**BRR**"). This information was made part of the annual report of the company and was also to be submitted to Indian stock exchanges. Initially, the BRR was mandatory for the top 100 listed entities based on market capitalization in BSE and NSE. This was subsequently increased to the top 1000 entities. Non-adherence to BRR reporting is considered a violation of Clause 55 of the Equity Listing Agreement. Other listed companies may voluntarily include BRR as part of their Annual Reports. This was the earliest initiative in India to integrate ESG into the country's regulatory system and make it mandatory for companies to disclose their ESG performance.[44]

4. Integrated reporting by SEBI, 2017

After the introduction of non-financial disclosures under the BRR, the information available on the performance of a company increased significantly. Companies were reporting on their financial performance, CSR initiatives, sustainability initiatives and responsible business practices. However, this information was available in different documents - Annual report, BRR, Sustainability report etc. - in different formats. To overcome this problem and to develop integrated thinking in the decision-making process, SEBI, in 2017, asked top 500 companies to shift to Integrated Reporting structure, which was developed by the International Integrated Reporting Council, on a voluntary basis.[45] The council defines the objective

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[44] MINISTRY OF FIN., GOV'T OF INDIA, (SEBI) BUSINESS RESPONSIBILITY REPORTS, https://www.sebi.gov.in/sebi_data/attachdocs/1344915990072.pdf.

[45] SEC. & EXCH. BD. INDIA, INTEGRATED REPOSTING BY LISTED ENTITIES, SEBI/HO/CFD/CMD/CIR/P/2017/10, (Feb. 6, 2017), https://www.sebi.gov.in/sebi_data/attachdocs/1486375066836.pdf.

of integrated reporting as to 'promote a more cohesive and efficient approach to corporate reporting that draws on different reporting strands and communicates the full range of factors that materially affect the ability of an organization to create value over time.'[46]

5. National Guidelines on Responsible Business Conduct (NGRBC), 2018

The NVGs released by the Ministry of Corporate Affairs, in 2011 was expected to provide guidance on responsible business conduct and the performance in this respect was captured through the BRR structure. However, there were some major developments in the following years including; The UN Guiding Principles for Business and Human Rights (2011), the Companies' Act 2013, UN Sustainable Development Goals (2015) and Paris Agreement on Climate Change (2015). In order to align the NVGs with these major developments, the revised updated guidelines known as the **National Guidelines on Responsible Business Conduct** ("**NGRBC**"), were released by the Ministry of Corporate Affairs in 2018.The revised principles address a range of issues including environmental safety, human rights, fair labour practices and business ethics.[47]

6. Business Responsibility and Sustainability Report (BRSR), 2021

After the introduction of the National Guidelines on Responsible Business Conduct ("**NGRBC**"), the Ministry of Corporate Affairs constituted Committee on Business Responsibility Reporting to revise the BRR format, to dovetail it with the revised guidelines. In May 2020, the committee developed and recommended **Business Responsibility and Sustainability Report ("BRSR")** format, to replace the BRR framework.

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[46] *Structure*, VALUE REPORTING FOUNDATION, https://www.integratedreporting.org/the-iirc-2/structure-of-the-iirc/ (last visited May 13, 2022).

[47] MINISTRY CORP. AFFAIRS, GOV'T OF IND., NATIONAL GUIDELINES ON RESPONSIBLE BUSINESS CONDUCT (2019), https://www.mca.gov.in/Ministry/pdf/NationalGuildeline_15032019.pdf.

The committee proposed two formats for disclosures, a comprehensive and a *lite* version. SEBI, through its circular in March 2021, made it mandatory for the top 1000 listed entities by market capitalization to make their disclosures as per the BRSR.[48] To start with, BRSR reporting would be on a voluntary basis for FY 2021-22 and will be mandatory from FY 2022-23. It is proposed to be extended to all listed companies in the next 5 years (Table 1).

Type of Organization	Non-financial Disclosures under BRSR
Top 1000 listed companies (by market cap)	• On a voluntary basis for FY 2021-22 • Mandatory from FY 2022-23 • Currently reporting under BRR
Other listed entities (small and mid-cap)	• Voluntary and encouraged to adopt BRSR *lite* • Proposed to be mandatory in 5 years
Non-listed companies/MSMEs	• Voluntary and encouraged to adopt BRSR *lite*

Table 1: Status of implementation of BRSR for non-financial disclosures by Indian Companies

The BRSR framework, which is a substantial improvement over the BRR, is considered as a significant step towards bringing non-financial reporting at par with financial reporting. The BRR framework, based on the NVGs, had a standard format to report on various initiatives taken by the companies for sustainable business practices. It was also felt that, though the disclosure of information under the framework was complete

[48] SEC. & EXCH. BD. IND., CIRCULAR FOR BUSINESS RESPONSIBILITY AND SUSTAINABILITY REPORTING BY LISTED ENTITIES, SEBI/HO/CFD/CMD-2/P/CIR/2021/562.

but lacking in clarity and accuracy.[49] The BRSR, on the other hand, has a more holistic approach and would include both qualitative and quantitative information on metrics related to key ESG issues. This will help different stakeholders to compare the performance of companies based on various non-financial indicators and also provide deep insights into the business policies and processes. The information can also be used by asset managers and investors to screen the companies that fail to perform on important ESG metrics.

ESG pillars	**Disclosure Requirement under BRSR**	**NGRBC Principles**
General	• An overview of the company's material ESG risks and opportunities and approach to mitigate or adapt to the risks, together with relevant financial implications • Sustainability related goals and targets and related performance • Management structures,	General management and process disclosures

[49] *Business Responsibility and Sustainability Report: An Attempt to mainstream ESG* (2021), PRICE WATER HOUSE COOPER, https://www.pwc.in/assets/pdfs/consulting/esg/business-responsibility-and-sustainability-report.pdf.

	policies and processes related to sustainability	
Environment	• Resource usage (energy and water) and intensity metrics • Air pollutant emissions • Greenhouse gas emissions (Scope 1, Scope 2 and Scope 3) • Waste generated and waste management practices Impact on bio-diversity	**Principle 6**: Businesses should respect and make efforts to protect and restore the environment
Social	*Employees* • Gender and social diversity including measures for differently-abled employees • Turnover rates • Median wages • Welfare benefits to permanent	**Principle 3**: Businesses should respect and promote the well-being of all employees, including those in their value chains **Principle 5:** Businesses should respect and promote human rights

	and contractual employees • Occupational health and safety Trainings	
	Communities • Social Impact Assessments • Rehabilitation and Resettlement • Corporate Social Responsibility	**Principle 8:** Businesses should promote inclusive growth and equitable development
	Consumers • Product labelling, Product recall • Consumer complaints in respect of data privacy, cyber security etc.	**Principle 9:** Businesses should engage with and provide value to their consumers in a responsible manner
Governance	• Training on the principles in the RBC Guidelines for members of the Board, senior managers and employees • Anti-corruption and anti-bribery policies	**Principle 1:** Businesses should conduct and govern themselves with integrity, and in a manner that is Ethical, Transparent and Accountable.

	• Awareness programs conducted for value chain partners on the principles in the RBC Guidelines	

Table 2: Connecting ESG, NGRBC and BRSR (*Source:* Uhrynuk, M.R, Burdulia, A and Lee, J.C (2021))

7. **SEBI consultation paper on Environmental, Social and Governance (ESG) Rating Providers for Securities Markets, 2022**

In January 2022, SEBI floated a consultation paper on regulating ESG rating providers in the country. It is expected that the flow of sustainable finance into the business will see an exponential increase in the coming years which will increase demand for more ESG products and subsequently demand ESG ratings in the securities market.[50]

It was found that the wide number of ESG rating players and related products were creating ambiguities in the absence of standard methodologies and definitions. There are also issues of transparency and conflicts of interest in the existing set-up. Some of the key proposals made in the paper are:

- Regulation of ESG ratings and other related products:
  - Currently wide range of ESG ratings and other related products are offered by various ESG rating providers

[50] SEC.& EXCH. BD. INDIA, CONSULTATION PAPER ON ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) RATING PROVIDERS FOR SECURITIES MARKETS (Jan. 24, 2022), https://www.sebi.gov.in/reports-and-statistics/reports/jan-2022/consultation-paper-on-environmental-social-and-governance-esg-rating-providers-for-securities-markets_55516.html.

(ERPs). There are ambiguities and inconsistencies in various terminologies, definitions and objectives of such products due to lack of transparency and inadequate disclosures on data, methodology etc.

- The ESG ratings market is largely unregulated and most of the ERPs also provide advisory services on ESG resulting in conflict of interest. This can result into misallocation of funds by investors and greenwashing (misleading information about a product/service/company to pass it as environment friendly)

- Eligibility for accreditation as ERP:
    - The paper has proposed that only SEBI-registered credit rating agencies and analysts should be accredited by SEBI as ERPs subject to the set criteria, which shall be based on net worth, infrastructure, manpower etc.
- Better categorization of rating products:
    - In the absence of any regulation and standards, there are a wide range ESG ratings and ESG products with varying methodologies followed by various ERPs. The ratings can be classified under two major heads; ESG "risk" ratings and ESG "impact" ratings. These two sets of ratings have different methodology and would also cater to different stakeholders. However, the current practice does not differentiate on this categorization.
- ESG rating process:
    - It is also proposed that proper process must be followed by the ERPs while preparing ESG ratings and other products. There should be consistency in methodology, in-depth research and evidences to support findings, trained staff, committee for ratings, due diligence while preparation of ratings, operating guidelines for the ESG rating process etc.
- Governance and prevention of conflict of Interest:

- ERPs should have a governance process in place and prepare a detailed policy on managing conflict of interest.

IV. ESG: THE DRIVING FORCE FOR CORPORATE GOVERNANCE 2.0

A. MAINSTREAMING ESG INTO BUSINESS OPERATIONS

The process for successful ESG integration into business operations would require it to become part of the company-wide decision making and embedded in the DNA of the corporate strategy. ESG integration would entail that the business decisions and strategies would take into consideration not just the profits but also its immediate and long term social and environmental impact. For example, the ESG lens should be used while assessing the supply chain, taking decisions on inclusion and diversity, corporate investing, risk management etc.[51]

The process of ESG integration can help businesses to analyse their operational efficiency and help in improving the long-term viability. It also helps in assessing the risks and opportunities for a business; for example, extreme weather conditions, increased air pollution and water scarcity pose direct risks to certain businesses whereas opportunities will increase in areas like green building, renewable energy or clean technology. Successful ESG integration has many benefits for any business; it attracts investors, builds and broadens a loyal customer base, helps in retention of talent, and improves risk management.[52]

Though the broader process of integration would remain similar, the finer details would vary depending on various factors like the sector, size, and location of the business. The first step in integrating ESG into business is to bring on board the key stakeholders and agree on the **definition of ESG** and its relevance for the business. This process would include sensitization of the board members and top management on their

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[51] Kezia Farnham, *The Board's Guide to ESG Integration,* DILIGENT INSIGHTS (May 14, 2021), https://insights.diligent.com/esg/integration/.
[52] Michelle Winters, *What is ESG integration and why is it important*, GOBY INC (Mar. 24, 2022), https://www.gobyinc.com/what-is-esg-integration/.

understanding of the value and relevance of ESG for the business and incorporating it in the purpose of the organisation.

ESG issues would vary for different companies depending on a number of factors like sector of operation, geographical location, size of the company, and as a result, the issues that need to be focused on will also vary. Also, for practical reasons, a company must identify major ESG issues that it wants to focus on. Through the process of **materiality assessment**, companies would identify and assess the most relevant ESG topics for their business and stakeholders. Materiality defines why and how certain issues are important for a business or a sector. Material issues can impact the financial as well as reputational and legal aspects of any business. The origin of the concept is in auditing and accounting where materiality refers to the significance of an amount, transaction, or discrepancy. The process of materiality assessment should take into consideration the purpose of the organisation, key ESG issues for the business and engage key stakeholders in this exercise.

After the identification of the material ESG issues, the company should put in place an **ESG governance structure** to monitor the overall progress. Sound ESG governance offers a solid foundation for functional board oversight and proactive management on ESG issues. The board should have members with relevant ESG expertise and experience. External experts can also be engaged to enhance the board's capabilities in ESG. Clear roles and responsibilities of the board members, as well as committees, should be defined in order to make the personnel/committees accountable and thus facilitate the overall development of ESG.

All ESG issues identified as material or strategically significant should be appropriately addressed in the company's **risk management** processes. Appropriate enterprise risk management ("**ERM**") framework should be applied to assess the ESG-related risks. Companies can also refer to the existing risk management frameworks for ESG related issues such as suggested by the World Business Council for Sustainable Development ("**WBCSD**").

ESG strategy is important to provide a roadmap for guiding the company's actions and provides a framework to engage stakeholders and drive performance. Successful implementation of such a strategy should contribute towards achieving the vision of the company and business growth. Studies have shown that a sound sustainability strategy minimises the reputational risks of a company and protects the brand.[53]

For ease of successful implementation and assessing the overall success of the ESG strategy for a business, it is important to have well defined **KPIs and targets** because, "if you can't measure it, you can't manage it". Hence, a robust data management system is imperative for any company for disclosures, target setting, monitoring and evaluating the ESG performance.

Regulators in many jurisdictions have now made it mandatory for businesses to make non-financial **("ESG") disclosures**. Businesses should not think of this as mere compliance but use the opportunity to assess their performance on these issues and undertake course correction if needed. Such information should also be communicated regularly with all the stakeholders. The company would also get an opportunity to showcase its contribution towards a society which would strengthen the brand value and gain the trust of all the stakeholders.

Effective communication channels should be setup to reach all stakeholders and inform them about the vision, direction and progress of relevant ESG issues. Companies can choose from various international reporting standards and frameworks for preparing their ESG or sustainability reports.

To keep the entire exercise unbiased and transparent, companies should seek **independent assurance**. This ensures that the reporting meets certain standards, builds trust and further strengthens the credibility of EGS

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[53] KPMG, *Integrating ESG into your Business*, KPMG, CLP, HKICS, https://assets.kpmg/content/dam/kpmg/cn/pdf/en/2020/01/integrating-esg-into-your-business.pdf. (last visited May 13, 2022).

information disclosed in their relevant reports. The independent assurance can be provided by the traditional external audit firms or other sustainability consulting firms. To further improve the robustness of the process, companies can also go for certification (for example GHG emission, waste water treatment) from specialized agencies. The level, scope and processes adopted for the assurance should also be made part of the report to showcase the authenticity of the report building processes.[54]

B. ROLE OF BOARD AND MANAGEMENT IN ESG INTEGRATION (INTERNAL DRIVERS)

The process of ESG integration has to be driven from the top and hence the role of the Board is critical. The Board should put in place a proper governance structure for ESG and be actively involved in the functioning of such structure. It should also be ensured that there is a robust stakeholder engagement process in place and all the stakeholders are engaged while developing the ESG policy for the organisation. The board should regularly review the ESG strategies and the performance of the company on the agreed ESG parameters to ensure relevance and continuity in reporting.

Management will be responsible for executing the ESG strategy chalked by the Board of Directors. Due to the increasing demand for information on non-financial parameters, management has to shift towards integrated thinking. Under this approach, the management has to go beyond financial capital and also think about other capital including natural, social and relationship, human, manufactured, and intellectual. Successful ESG integration would need effective management of all types of capital and value creation through them.[55]

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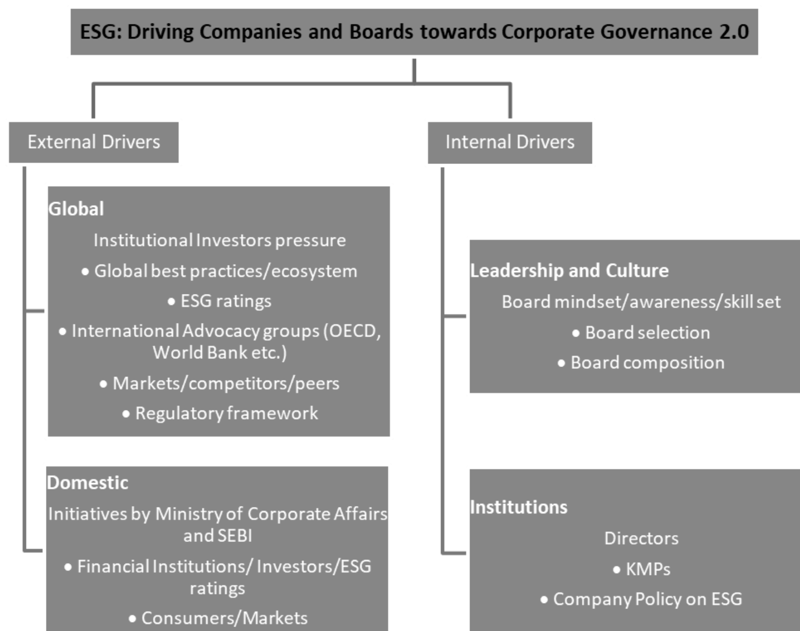
[54] *Id.*

[55] International Finance Corporation (2022), "IFC ESG Guidebook", https://www.ifc.org/wps/wcm/connect/3435180b-6506-4960-86ed-a0beabdcb02e/IFC-ESG-Guidebook2.pdf?MOD=AJPERES&CVID=nSBhl7-

C. APPRECIATING DRIVING FORCES (EXTERNAL DRIVERS)

There are also various external drivers, at the domestic and international level, that affect the adoption of ESG into business operations. This includes various initiatives in the form of laws, rules, guidelines etc. by the Ministry of Corporate Affairs, SEBI and other regulatory bodies, and pressure from institutional investors and consumers to shift towards more sustainable business practices. At the international level, there are guidelines set by advocacy groups like World Bank, OECD etc. which is largely driven by global institutional investors and other bodies which are directing companies to address various ESG issues in their business operations (see chart 1).



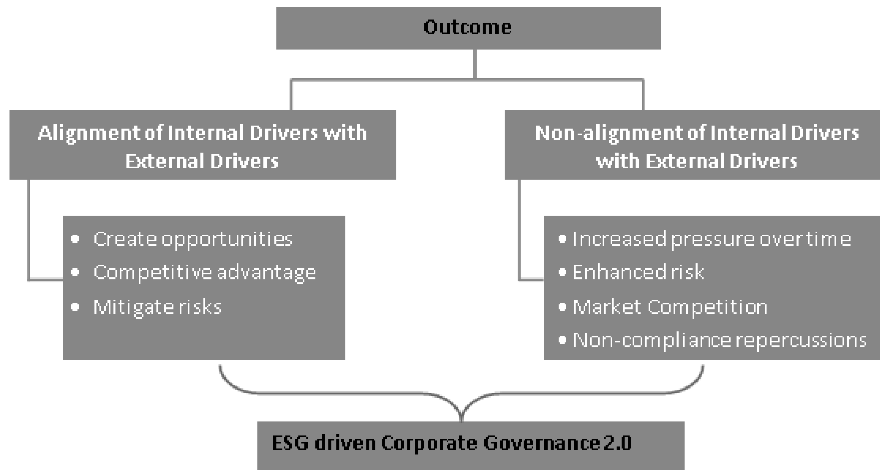


Chart 1: ESG Driven Corporate Governance 2.0 (*Source:* Authors)

V. CONCLUDING REMARKS BASED ON EVIDENCES FROM ACTION RESEARCH

The importance of the adoption of ESG issues by the companies can be derived from the philosophy of stakeholder capitalism. According to this philosophy, companies should seek long term value creation and should take into account the needs of all their stakeholders and society at large.[56] This can involve creating secure jobs for employees, embracing sustainable practices, serving customers loyally, cultivating long-term supplier relationships, paying fair taxes or working to minimize the environmental footprint of operations.[57] In the backdrop of various disruptions caused by the COVID-19 pandemic, more investors now believe that companies that perform well on ESG parameters are likely to be less risky and are better

[56] Klaus Schwab & Peter Vanham, *What is Stakeholder Capitalism,* DAVOS AGENDA, WORLD ECON. FORUM (Jan. 22, 2021), https://www.weforum.org/agenda/2021/01/klaus-schwab-on-what-is-stakeholder-capitalism-history-relevance/.

[57] Matthew Bell, *Why ESG performance is growing in importance for investors,* EY (Mar. 9, 2021), https://www.ey.com/en_in/assurance/why-esg-performance-is-growing-in-importance-for-investors.

prepared in the long run to meet various uncertainties compared to those that follow the business-as-usual approach.[58]

ESG integration is also directly related to the financial performance of the businesses. The non-financial initiatives help in improving and maintaining a good corporate reputation which further strengthens the brand image. This also helps to attract, retain and motivate employees, improve risk management and strengthen the overall competitive position of the organization.[59] Along with the long term value creation, companies need to have sound business strategies for safeguarding such value. Managing various ESG factors also helps companies in identifying risks associated with these issues and improves the overall Enterprise Risk Management ("**ERM**") strategy. Neglecting ESG issues can damage the reputation of the company and can also lead to financial loss and erosion of value.

A growing number of investors are now choosing investment opportunities (stocks, funds etc.) that are not just profitable but also fulfil certain social values. Estimates show that the size of global ESG assets at the end of 2021 is estimated at USD 37.8 trillion and is expected to reach USD 53 trillion by 2025, which will be more than one-third of the total assets under management ("**AUM**").[60] Reporting on ESG performance is also being demanded by the regulators and the rigor of such disclosures will further increase in the future. Companies that are already reporting their performance on various ESG metrics will find it easier to comply with such requirements. Businesses ignoring ESG as a passing fad would be doing it at their own peril. Environmental and social challenges have redefined the way state's function and businesses operate. ESG was part of the World Economic Forum's 2021 Davos summit agenda, which shows that the

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[58] *Id.*

[59] Lindsay Delevingne et al, *The ESG premium: new perspectives on value and performance*, MCKINSEY SURV. (2021).

[60] Research, *ESG assets may hit $53 trillion by 2025, a third of global AUM*, BLOOMBERG INTELLIGENCE, https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/ (last visited May 13, 2022).

notion will gain further traction in the near future. Integration of ESG metrics into financial reporting and product innovation will further gain momentum and will substantially change the way business is conducted.[61]

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[61] Jeff McDermott, *ESG: Fad or Future?* NOMURA (July 7, 2021), https://www.nomuraconnects.com/focused-thinking-posts/esg-fad-or-future/.

MONITORING INDEPENDENT DIRECTORS: WHO WILL GUARD THE GUARDS?

Rajat Sethi & Sarangan Rajeshkumar[*]

ABSTRACT

Since the introduction of the concept through the Companies Act, 2013, independent directors are perceived as an easy remedy to poor corporate governance. Their efficacy in effectively monitoring company management is often taken at face value. Studying recent instances of corporate governance lapses provides an insight into the efficacy of independent directors. To plug these gaps, regulators constantly strive to raise the bar on the relevant criteria for determining the independence, and the procedure for the appointment, of independent directors. However, the changes affected do not appear to address the problem at hand. The ability of independent directors to effectively monitor company management has been questioned in the United States. Unlike in India, shareholders have often pursued derivative claims against independent directors. While these derivative actions are not always successful, they function as an additional check on independent directors' actions. Derivative actions are also pursued by shareholders in India. However, they: (a) are rarely pursued against independent directors; and (b) typically arise out of situations where directors have committed a fraud on the shareholders rather than when they have simply failed to perform their duties. For independent directors in India to function as an effective check on management, the threat of shareholder action needs to be a real one.

Keywords: Corporate Governance, Independent Directors, Shareholders.

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I. INTRODUCTION

Independent directors form a cornerstone of corporate governance regulation across the world. In India, a large number of companies are required to appoint independent directors to their boards. Such directors are expected to act as a check on promoters and executives. In this article, the authors examine the efficacy of independent directors in performing this expected role.

The legislature is cognizant of the fact that independent directors may not be functioning as an effective form of control over management – this is evident from the spate of amendments that have been passed over the years concerning the appointment and qualification of independent directors. The authors examine such regulations and consider if they have achieved their desired result. The authors also examine regulations relating to the degree of liability that can be attributed to independent directors and the consequence of such regulations.

In addition to regulatory action, another way in which independent directors can be held to account is through shareholder-led litigation. The authors consider how such litigation has been pursued in the United States and whether such litigation will assist with strengthening corporate governance in India.

II. REGULATIONS CONCERNING APPOINTMENT AND QUALIFICATION

The predecessor legislation to the Companies Act, 2013, i.e., the Companies Act, 1956, did not expressly require companies to appoint independent directors to their boards (although the stock exchange listing agreement prescribed certain requirements in respect of publicly listed companies). With the notification of Section 149 of the Companies Act, 2013, every listed company as well as unlisted public companies whose share capital, turnover or borrowings exceed certain specified thresholds are required to appoint a minimum number of independent directors. A minimum number of independent directors are also required on certain committees of the board, such as the audit committee. Additional requirements are also prescribed under the SEBI's Listing Obligations and Disclosure Requirements Regulations, 2015 ("**LODR Regulations**") and under the listing agreement executed with the stock exchanges, in respect of listed companies.[1]

The criteria for determining who can be appointed as an independent director under the Companies Act are fairly extensive. Independent directors are required to be persons who *inter alia*: (a) are not related to the relevant company's promoters; (b) do not receive remuneration or otherwise have any pecuniary relationship with the relevant company exceeding certain thresholds; (c) are not related to persons who hold securities of the relevant company or have any pecuniary relationship exceeding thresholds; (d) do not or have not previously served as the relevant company's auditors or consultants; (e) do not hold securities in the relevant company exceeding certain thresholds; or (f) do not hold a position in a non-profit organization that receives significant receipts from the relevant company.[2] They are also required to be persons who, in the opinion

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[1] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Gazette of India, pt. III sec. 4, Reg. 16, 17, 18 & 19 (Sep. 2, 2015).

[2] Companies Act, No. 18 of 2013, § 149(6) (Ind.).

of the board, are persons of integrity and possess relevant experience.[3] Additionally, independent directors are required to complete a test organized by the Indian Institute of Corporate Affairs.[4] The Companies Act also prescribes limits on the tenure of independent directors and the number of consecutive terms for which a person may be appointed as an independent director.[5] Further, in the case of listed companies, the LODR Regulations require independent directors to be appointed by a special resolution of the company's shareholders (i.e., a 75% majority).[6]

These checks and balances have made the process for the appointment of independent directors a rigorous one. However, they have not entirely worked out in the way that one would have hoped in ensuring that independent directors act in the best interests of the company and not on behalf of promoters or other vested interests. In 2002, Vice Chancellor Strine of the Delaware Chancery Court famously portrayed controlling shareholders "*as the 800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors who might well have been hand-picked by the gorilla (and who at the very least owed their seats on the board to his support)*."[7] This statement remains relevant for India in 2022 despite all the checks and balances that have been instituted; controlling shareholders or promoters remain as powerful and assertive as they were before the concept of independent directors was introduced.

To understand why certain independent directors may continue to act for vested interests, one needs to examine what sanctions follow for such behaviour. The scope of such sanctions is set out in the rules concerning

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[3] *Id.*
[4] Companies (Appointment and Qualification of Directors) Rules, 2014, Gazette of India, pt. II sec.3(i), Rule 6 (Sep. 18, 2014).
[5] Companies Act, No. 18 of 2013, § 149(10) (Ind.).
[6] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Gazette of India, pt. III sec. 4, Reg. 25(2A) (Sep. 2, 2015).
[7] In re Pure Res. S'holders Litig. - 808 A.2d 421 (Del. Ch. 2002).

the liability of independent directors.

III. REGULATIONS CONCERNING INDEPENDENT DIRECTORS' LIABILITY

Independent directors are offered a significant degree of immunity under the Companies Act. Section 149(12) of the Companies Act states that independent directors "*shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently.*"[8]

The Ministry of Corporate Affairs has also reiterated this in its circular dated March 2, 2020, which states that "*in case lapses are attributable to the decisions taken by the board or its committees, all care must be taken to ensure that civil or criminal proceedings are not unnecessarily initiated against independent directors or non-executive directors unless sufficient evidence exists to the contrary*".[9]

Similarly, Regulation 25(5) of the LODR Regulations states that "*an independent director shall be held liable, only in respect of such acts of omission or commission by the listed entity which had occurred with his/her knowledge, attributable through processes of the board of directors, and with his/her consent or connivance or where he/she had not acted diligently with respect to the provisions contained in these regulations.*"[10]

Courts too have cautioned against attributing liability to independent (and even non-executive) directors – they reason that independent directors are not responsible for the conduct of the company's business.[11]

These rules attempt to strike a balance between the responsibility of

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[8] Companies Act, No. 18 of 2013, § 149(12) (Ind.).

[9] Ministry Corp. Affairs, Gov't of Ind., General Circular No. 1/2020 (Jan. 1, 2020).

[10] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Gazette of India, pt. III sec. 4, Reg. 25(5) (Sep. 2, 2015).

[11] *See* Pooja Ravinder Devidasani v. State of Maharashtra, (2014) 16 SCC 1; Chintalapati Srinivasa Raju v. Securities and Exchange Board of India, (2018) 7 SCC 443; Sunil Bharti Mittal v. Central Bureau of Investigation, (2015) 4 SCC 609.

independent directors and avoiding unnecessary prosecutions which might discourage well-qualified candidates from acting as independent directors. While the rules themselves cannot be faulted, their application to specific fact situations has left much to be desired.

IV. LAPSES IN CORPORATE GOVERNANCE AND THE ROLE OF INDEPENDENT DIRECTORS

Lapses in corporate governance have hardly ceased after the requirement to appoint independent directors to the boards of companies. Companies such as Yes Bank, Videocon, and CG Power and Infrastructure continue to carry the burden and stress caused by maladministration and in some cases alleged fraud by their erstwhile promoters. Independent directors did not act as an effective safeguard in any of these cases.

The reason for this, in many cases, is that independent directors themselves do not have the complete picture of the company's affairs and find it difficult to monitor promoters. Further, they often find it difficult to pinpoint wrongdoing even when they are aware that the company affairs are not what they are portrayed to be. In a number of such cases, independent directors may have no option but to resign. A recent study found as many as 1344 independent directors to have resigned from the boards of listed companies during the financial year ended March 31, 2020.[12] Such resignations can serve as an effective way to highlight issues in a company. For example, in the case of PTC India Limited, an independent director resigned from the board citing "serious governance issues with several defaults of the Companies Act and the SEBI LODR Regulations".[13] Such resignation followed the resignations of three other independent directors from the board of the company's subsidiary, PTC Financial

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[12] K. Vijayaraghavan et al., *Exodus of Independent Directors Gains Pace on Reputational and Legal Concerns,* ECON. TIMES (Sep. 7, 2020) http://www.primedatabasegroup.com/newsroom/M486.pdf.

[13] Letter from Rakesh Kacker et al., Independent Director, PTC India Ltd., to National Stock Exchange of India Ltd. (Jan. 21, 2022) https://www.bseindia.com/xml-data/corpfiling/AttachHis/f8ce1c15-1bcd-45b4-8ded-258d0c945c79.pdf [hereinafter Rakesh Kacker].

Services Limited, who had flagged issues in loans that had been granted by PTC Financial Services and complained that the management of the company did not pay heed to the independent directors' advice or share relevant information with the board.[14]

There are examples at the other end of the spectrum as well. For example, in the case of Future Retail, Amazon intervened in Reliance's proposal to acquire the company and successfully brought an end to the acquisition through litigation proceedings.[15] Subsequently, independent directors on Future Retail's board wrote to the Competition Commission of India ("**CCI**") requesting the CCI to revoke the approval that it had granted to Amazon for its investment in Future Coupons Private Limited (Future Retail's promoter entity).[16] Notably, these representations have been made almost three years after Amazon's investment in Future Coupons Private Limited – the timing of the representations alone leads one to question the motives of the independent directors.

Independent directors also have a duty to hold other directors to account and question them when they believe that such directors' actions are not in the best interests of the Company. For instance, in the case of Zee Entertainment, the company's managing director has admitted that when he had received an acquisition offer in February 2021, he did not present the offer to the board (or even keep the board informed of the offer) because "in his considered view, the deal was not in the best interests of the public shareholders"[17]. When the February 2021 proposal become public in October 2021, the managing director's reasoning seems to have been accepted by the board on the face of it without any questions being

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[14] *Id.*

[15] Utkarsh Anand, *Decoding the multilayered Amazon-Future-Reliance legal drama*, HINDUSTAN TIMES (Jan. 10, 2022) https://www.hindustantimes.com/india-news/decoding-the-multilayered-amazon-future-reliance-legal-drama-101641839370846.html.

[16] Indu Bhan, *CCI suspends Future deal, fines Amazon*, FIN. EXPRESS (Dec. 18, 2021) https://www.financialexpress.com/industry/cci-suspends-future-deal-fines-amazon/2382815/.

[17] Rakesh Kacker, *supra* note 13 at 36.

raised as to his disclosure obligations to the rest of the board.

Such examples underscore that in many instances, independent directors may be independent in name only. They are brought on to companies' boards only for the purpose of meeting the requirements set out in the Companies Act and LODR Regulations and do not, in reality, serve as a check on the promoters or the executive management.

V. EXPERIENCES FROM THE UNITED STATES

In the United States as well, the efficacy of having independent directors on companies' boards has been questioned including the very belief that "outsiders are well-equipped to monitor insiders and that independent supervision is the best way to increase the company's performance".[18]

Regulators have generally not pursued actions against independent directors for a failure to act although, in certain instances, they have held independent directors liable for wilful neglect. For example, in the case of DHB Industries, a supplier of body armour to the U.S military, the Securities and Exchange Commission ("**SEC**") brought an enforcement action against certain independent directors. In this case, DHB had been found guilty of accounting and disclosure fraud, and certain executives of DHB were found to have misappropriated the company's assets. The SEC found that the company's executives were able to carry out their scheme for over three years because its independent directors and audit committee members were "*were willfully blind to numerous red flags signalling accounting fraud, reporting violations and misappropriation at DHB...they ignored the obvious and merely rubber-stamped the decisions of DHB's senior management*."[19]

However, in addition to regulatory action, checks and balances take

[18] S Burcu Avci et al., *The Elusive Monitoring Function of Independent Directors*, 21(2) U. PA. J. BUS. L. (2018).

[19] SEC v. Krantz, Chasin, and Nadelman, No. 0:11-cv-60432-WPD (S.D. Fla. filed Feb. 28, 2011).

another form as well in the United States – that of shareholder derivative actions. Essentially, a derivative action is a suit brought by a shareholder on behalf of a company to assert a cause of action against a person (usually a director) who has committed a wrong against the company where the company itself has failed to sue for its injuries. Note that such actions are different from remedies such as oppression and mismanagement available under the (Indian) Companies Act since: (a) they are meant to address wrongs against the company itself rather than against its shareholders (b) are common law remedies not codified in legislation.

Such actions against directors are quite common in the United States and act as a threat to ensure that directors discharge their duties with diligence.

For instance, in the case of Boeing, the company's shareholders sued its directors in connection with two airline crashes involving Boeing Max 737 aircrafts which resulted in the death of 346 passengers and the grounding of all 737 Max aircrafts. The shareholders alleged that the company's directors and officers had breached their fiduciary duties by failing to effectively supervise the aircraft's design and development. They further argued that the directors had ignored various safety-related red flags.[20] The derivative claims, in this case, were pursued by the New York State Common Retirement Fund and the Fire and Police Pension Association of Colorado, who were institutional shareholders in the company. The directors against whom the claims were pursued included several independent directors who were retired executives as well as former employees of various US government bodies. The proceedings ultimately concluded with the filing of a settlement agreement which included a $237 million cash pay-out. The directors further agreed to implement an

[20] *Verified Amended Consolidated Complaint*, IN RE THE BOEING COMPANY DERIVATIVE LITIG., CONSOL. C.A. NO. 2019-0907-MTZ (DEL. CH.) SETTLEMENT WEBSITE (Feb. 5 2021), https://boeingderivativesettlement.com/wp-content/uploads/2021/12/02-05-21-Boeing-Public-Version-Amended-Complaint.pdf.

ombudsman program providing employees with a channel to raise safety-related issues.[21]

In the case of ***Blue Bell Creameries***,[22] one of the USA's largest ice cream manufacturers, a listeria outbreak in 2015 caused the company to recall all of its products, shut down production at all of its plants, and lay off over a third of its workforce. The outbreak also resulted in the death of three persons. Less consequentially (but significantly to the litigation), Blue Bell suffered a liquidity crisis that forced it to accept a dilutive private equity investment. The derivative claim brought by one of the company's shareholders alleged that two of the company's officers had knowingly disregarded contamination risks and failed to oversee the safety of Blue Bell's food-making operations and that the directors had failed to exercise their duty of care. The court found that "*the board's lack of efforts resulted in it not receiving official notices of food safety deficiencies for several years, and that, as a failure to take remedial action, the company exposed consumers to listeria-infected ice cream, resulting in the death and injury of company customers*".

Derivative actions themselves are, however, not always successful. For example, in the case of Capital One, the shareholders of the company brought an action against its directors for failing to monitor Capital One's compliance with anti-money laundering laws.[23] This was preceded by a consent order passed by the Office of the Comptroller of Currency which found that Capital One had failed to adopt and implement a compliance program and that it had an inadequate system of internal controls and ineffective independent testing. The Court of Chancery in Delaware, however, ultimately dismissed the derivative claim against the company's directors stating that directors can be held liable only when they had actual knowledge of corporate misconduct and consciously disregarded their duty

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[21] *Stipulation and Agreement of Compromise, Settlement, and Release*, IN RE THE BOEING COMPANY DERIVATIVE LITIG., CONSOL. C.A. NO. 2019-0907-MTZ (DEL. CH.) SETTLEMENT WEBSITE (NOV. 5, 2021), https://boeingderivativesettlement.com/wp-content/uploads/2021/12/boeing-settlement-agreement.pdf.

[22] Marchand v. Barnhill, C.A. No. 2017-0586-JRS (Del. Ch. June 19, 2019).

[23] Reiter v. Fairbank, 2016 WL 6081823 (Del. Ch. Oct. 18, 2016).

to address that wrongdoing.[24]

Irrespective of the success or failure of individual cases, the larger point remains that the threat of shareholder litigations looms large in the United States. This potentially acts as an important factor in incentivizing directors to exercise care and due diligence in discharging their duties.

VI. DERIVATIVE ACTIONS AGAINST DIRECTORS IN INDIA

Derivative actions against directors are not uncommon in India. However, they tend to be pursued in instances where directors have defrauded the Company, such as by siphoning off funds. For example, in the case of ***Genelec***,[25] an action for winding up was pending against the company. Before any order could be passed for the appointment of a provisional liquidator, certain properties were sold by Genelac's directors to other companies at a significant discount to the properties' market value. The plaintiff who was a shareholder in the company was able to successfully pursue a derivative action against the directors before the High Court of Bombay.

In the case of ***Paramount Coaching***,[26] the plaintiff was a shareholder who held 50% of the share capital of the company. The derivative action was filed by him against his wife who was a director of the company and who owned the remaining 50%. It was alleged that she had incorporated another company for the purposes of competing with Paramount and had diverted business, staff, customers and funds, from Paramount to such company. The Delhi High Court held that a derivative action was maintainable against the director and that she had breached her fiduciary duties to the company. It further issued an injunction against her and her new enterprise preventing them from using the mark "Paramount" and

[24] *Id.*
[25] Nirad Amilal Mehta v. Genelec Limited, [2008] 146 CompCas 481(Bom).
[26] Rajeev Saumitra v. Neetu Singh, CS(OS) No.2528/2015.

from competing with the company.

In the case of ***Gharda Chemicals***,[27] a derivative action was pursued against one of the directors of the company for registering certain patents in his name rather than in the name of the company. The Supreme Court, while holding that a derivative action would be maintainable, ultimately dismissed the case since it found that the plaintiff, who had pursued the claim as a minority shareholder, was in fact a competitor who did not appear to be acting in good faith.

From these cases, what is evident is that derivative actions in India tend to arise in cases where executive directors have committed fraud or deceit and, in some instances, are used by shareholders to settle personal scores. There have not been any significant derivative litigations where shareholders have attempted to hold directors of companies liable for losses faced by the company for lapses in management – there have been several instances of corporate governance failures where such actions would have been appropriate. This can, perhaps, be attributed to a few factors. First, litigation in India can be time-consuming. The judicial system is difficult to navigate and shareholders (especially retail investors) have little incentive in spending time and money on pursuing such actions. There is a significant amount of uncertainty in recovery as well. Secondly, derivative actions require several minority shareholders to cooperate – and accordingly, suffer from a collective action problem. Shareholders are thus, more likely to dispose of their stake in companies that have generated losses for them rather than try to recover them.[28]

VII. CONCLUSION

In the absence of a better remedy to poor corporate governance, the role of independent directors remains a crucial one – oversight is necessary

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[27] Darius Rutton Kavasmaneck v. Gharda Chemicals Limited, 2014 AIR(SCW) 6441.

[28] Umakanth Varottil & Vikramaditya S. Khanna, *The Rarity of Derivative Actions in India: Reasons and Consequences*, in THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH (D.W. PUCHNIAK et al ed., Cambridge University Press 2012).

from within companies since regulators and the general public are only aware of what is disclosed to them. While criminal and regulatory sanctions may be possible in certain cases, the threshold for imposing such sanctions should be high.

So far legislative efforts have focused on strengthening the process for appointment of independent directors and narrowing the criteria for establishing independence. However, this has not yielded the desired results. This is evident from recent instances of corporate governance failures.

In situations of lapses in management which may not reach the level of criminal wrongdoing, shareholders need to take up the mantle of holding directors to account in cases where companies face losses on account of mismanagement. While individual or retail shareholders may not have the resources to pursue such litigations, institutional shareholders are well placed to play this role. There have been emerging trends of institutional shareholders playing a more active role in India than has been so far the case; the authors submit that this trend will become significantly more pronounced in the foreseeable future.

CORPORATE GOVERNANCE IN SECURITIES FRAUD PREVENTION, CONTROL AND IMPROVING FIRM VALUE: EVIDENCE FROM INDIA

Dr. Preetha S & Manjula R S *

ABSTRACT

Corporate governance is the mantra for gaining the trust of investors in the economy. Unless investors are taken into confidence, mobilisation of funds to the corporation would get detrimentally reduced, thereby stagnating growth in the capital market. A pressing concern is the devastating effect of securities fraud that can lead to deplorable losses for gullible investors. The insatiable greed of financial fraudsters with an unceasingly hungry eye presents innovative and unprecedented challenges to the regulator and policy-makers, making securities fraud detection almost impossible. The present study attempts to understand how a good corporate governance framework in India can aid in improving firm value and fraud prevention. By first analysing the important ingredients necessary to bring in value maximisation of firms such as by understanding the ideal synergies of the board in the form of board diversity, board independence, size, composition etc. the study also looks at how corporate governance can also help in stock -market development. The study also presents how a well-reviewed corporate governance framework can also help in identifying the red flags of securities fraud detection. In this analysis, some of the stumbling blocks that evidence in the form of definitional opaqueness, lack of regulatory insight, innovativeness of the fraudster etc. are discussed. The authors feel that the regulator needs to brace up for answering societal expectations and outcomes of public interest whenever an instance of securities fraud is unearthed. The study presents suggestions to improve corporate governance norms that can help in early fraud detection and prevention. The

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study is important not only in understanding the challenges that fraud brings along necessitating to gear up the legislative and corporate system but also in understanding what ethical corporate governance practices hold for an emerging economy like India which is eyed for foreign investment.

Keywords: Board efficiency, corporate governance, firm value, fraud detection, securities fraud, stock market development.

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I. INTRODUCTION

A sound corporate regulatory system is a necessity for robust economic development. The history of corporate fraud has shown that there is a deep connection between the incidence of fraud and weakened corporate governance mechanisms in a firm. A corporate governance system with weakened internal controls such as the board of directors have higher chances of fraud incidence.[1] The board of directors are responsible for reviewing the activities and decisions of management.[2] A good corporate governance is useful in preventing fraud as evidence points out that firms which have involved in fraud do not have good corporate governance

[1] Mark S. Beasley, *An Empirical Analysis of the Relation between the Board of Director Composition and Financial Statement Fraud*, 71 THE ACCT. REV. 443–465 (1996).
[2] Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & Econ. (1983).

values.[3] The nature and scale of fraud risks in India show that the regulatory system needs to be fine-tuned to effectively manage the incidence of fraud and risk so as to ensure good corporate governance. Instances of fraud in Sathyam computers, Speak Asia, Sharadha chit fund, Sahara, NSEL etc. have shaken the markets and affected investor confidence. The role of corporate governance cannot be undermined considering the gamut of corporate activities, decisions, and investments that have an impact on the capital formation which further triggers a positive effect on market capitalization.[4] Particularly, in the grim context of the COVID-19 pandemic, there has been a burgeoning emphasis on following standards of corporate governance to prevent systemic shocks. The Corporate Governance Fact Book 2021 published by The Organisation for Economic Co-operation and Development ("**OECD"**) states *"Good corporate governance and well-functioning capital markets are always important, but perhaps even more critical now, both to support the recovery from the COVID-19 crisis and to further strengthen resilience to possible future shocks."*[5] It has also been found with reference to India that companies with better governance index scores generated higher returns.[6] Where companies had followed better governance, it was also found that in such companies developmental financial institutions lent monies and mutual funds invested their funds..[7] A look into corporate governance in the context of corporate securities fraud is also interesting within the Indian setting considering the fact that India is an emerging

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[3] S.A. TER WEELE, TILBURG UNIV., CORPORATE GOVERNANCE AND FRAUD INCENTIVES (2011).

[4] Naresh Kumar, *Estimation of Market Capitalization and Economic Growth in India,* SSRN (Jan. 31, 2014), https://ssrn.com/abstract=2388553 (last visited Dec 25, 2021) [hereinafter Naresh, *Estimation of Market Capitalization*].

[5] OECD, OECD CORPORATE GOVERNANCE FACTBOOK (2021) [hereinafter OECD, CORPORATE GOVERNANCE FACTBOOK].

[6] Pitabas Mohanty, *Institutional Investors and Corporate Governance in India*, SSRN (2003), https://papers.ssrn.com/abstract=353820 (last visited Dec 11, 2021) [hereinafter Pitabas, *Institutional Investors*].

[7] *Id.*

market with growth projected at 8 % for year 2022 as per IMF Report.[8] Figure 1 indicates the growth potential calculated from the IMF forecast of 2017.[9]

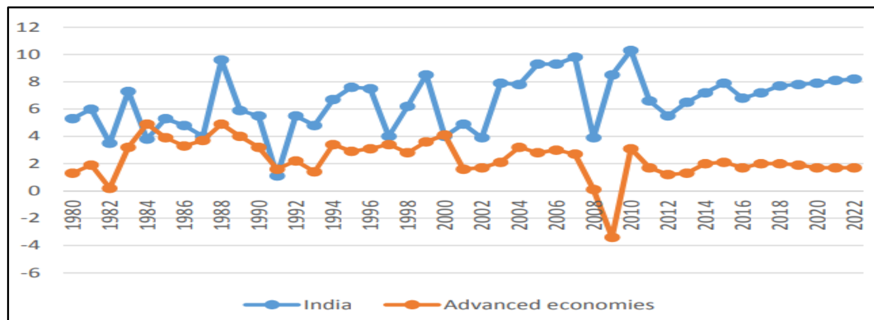

Figure 1:Real GDP Growth rate: Indian and Advanced economies

It is also found that generally there is a significant role that Multi-National Companies(“**MNC**”) can play in improving corporate governance in emerging markets.[10] Moreover, controlling investors *i.e.,* investors or shareholders with the ability to influence the composition of the board of directors and affect the activities of the company in developing capital markets enjoy greater authority than similarly situated shareholders in well-developed mature markets such as in the United States.[11] In addition to the above reasons, the investment interest has been rising in emerging economies like India and China.[12]

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[8] IMF, *A Shifting Global Economic Landscape* 1-7 (Jan. 2017). \

[9] Muneza Kagzi & Mahua Guha, *Does board demographic diversity influence firm performance? Evidence from Indian Knowledge Intensive firms*, 25(2) BENCHMARKING: AN INT’L JOURNAL (2018); *See also* Raj Aggarwal et al, *Board diversity and firm performance: The role of business group affiliation*, 28 INT’L BUS. REV. 101600 (2019).

[10] Nadia Albu et al, *Multinationals as Vectors of Corporate Governance Improvement in Emerging Economies in Eastern Europe: A Case Study*, CORP. GOV. IN EMERGING MARKETS: THEORIES, PRACTICES AND CASES 331–349 (2014).

[11] Kee H. Chung & Jeong-Kuk Kim, *Corporate Ownership and the Value of a Vote in an Emerging Market*, 5 J. CORP. FIN. 35–54 (1999).

[12] Yan-Leung Cheung et al., *Corporate Governance and Firm Valuation in Asian Emerging Markets*, CORP. GOV. IN EMERGING MARKETS: THEORIES, PRACTICES AND CASES 27–53 (2014).

There is a direct connection between the quality of corporate governance practices and firm value, especially in emerging markets.[13] Value maximisation has been linked to corporate governance frameworks that provide stronger shareholder rights.[14] On the other hand, corporate governance frameworks that result in frail shareholder rights can easily manifest agency problems which directly leads to low firm value.

Corporate governance is also important considering the impact of unregulated corporate business that can lead to instances of fraud in the market. Internationally, the study conducted by the Association of Certified Fraud Examiners in the year 2020 from data across 125 countries shows that an enormous quantum of $3.6 Billion loss has been caused due to fraud world-over. In the context of securities fraud, it is found that fraud creates devastating effects on the market. It is also found that the effect fraud creates is democratic i.e., its destruction is widely spread and shared by all.[15] In fact, the history of securities scams is itself replete with numerous instances of fraudsters causing massive losses to investors. For example, the Harshad Mehta market scam, one of India's first large-scale fraud prosecutions involved a laundered amount of Rs. 24,000 crore in 1992. In the Sahara scam alone Rs. 24000 Crores were raised from 2-2.5 Crores of gullible investors *via* OFCD. The Supreme Court of India ordered to refund around Rs. 17,400 crore to the investors with an interest of 15%.[16]

In the foregoing discussions, an attempt is made to draw inference on how corporate governance is linked to various important concepts such as stock market development and firm value enhancement. It is also appraised as to how an efficient corporate governance framework can tackle the

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[13] *Id.*

[14] Paul A. Gompers et al, *Corporate Governance and Equity Prices*, 118 Q. J. ECON., 107-155 (2003) [hereinafter Gompers].

[15] ACFE, REPORT TO THE NATIONS: 2020 GLOBAL STUDY ON OCCUPATIONAL FRAUD AND ABUSE (2020).

[16] Securities Exchange Board of India v. Sahara India Real Estate Ltd, (2013) 1 SCC 1 (Ind.).

menace of fraud in the market, particularly to see how securities fraud can be prevented. It is also part of the assessment to see how definitional opaqueness and regulatory incapacities have aggravated the problem of detection of market abuse through securities fraud. The Report of the Committee on Fair Market Conduct published by SEBI has taken note of many of the pressing definitional anomalies and ambiguities in various anti-fraud regulations such as the SEBI (Prohibition of Insider Trading) Regulations, 2015 and SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Markets) Regulations, 2003.[17]The present study is vital because a fair and efficient securities market is of paramount importance for the economic growth of a country. Moreover, prevention of market abuse and preservation of market integrity is the hallmark of securities law which is highlighted in this study.[18]

II. RELATIONSHIP BETWEEN CORPORATE GOVERNANCE, STOCK MARKET DEVELOPMENT, ENFORCEMENT, AND FIRM VALUE

The following discussion revolves around *firstly* on how corporate governance is directly linked to stock market development. When ambiguous and ill-structured corporate governance norms are present coupled with weak disclosure regimes, it takes a toll on the development of stock markets which would remain under-developed and illiquid.[19] On the other hand, when a country has in place well-developed corporate governance norms, it is found that shareholders have benefitted through higher returns.[20] Thus, a discussion on the influence of corporate governance on stock market development is important and undertaken

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[17] SEBI,REPORT OF COMMITTEE ON FAIR MARKET CONDUCT FOR PUBLIC COMMENTS (2018), https://www.sebi.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html?msclkid=f7e24855c57f11ec8ba42be8f0fbe2bb..

[18] N. Narayanan v. Adjudicating Officer, AIR 2013 SC 3191 (Ind.).

[19] Umakanth Varottil & Richa Naujoks, *Corporate Governance in India: Law and Practice,* SSRN (2016) https://papers.ssrn.com/abstract=2951705 (last visited Apr 27, 2022).

[20] Vince Hooper et al., *Governance and Stock Market Performance*, 33 ECON. SYSTEMS 93–116 (2009).

hereunder. Under this *first* part, the importance of investor protection, and an effective disclosure regime is investigated with a focus on the statutory overhaul made through the Companies Act, 2013, by repealing the erstwhile Companies Act, 1969. The *second* part of the discussion is centred around how corporate governance propels firm value enhancement. Here, is a look into how board composition, size, board diversity, independence, presence of women on board etc. are appraised.

D. RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND STOCK MARKET DEVELOPMENT

Capital formation of companies is enabled through the stock market. In addition to a steady capital market providing efficient capital raising opportunities for corporations, it also helps in channelizing domestic savings into real investment in more productive uses and thus facilitating efficient resource allocation.[21] Developing equity culture and drawing more investors to park their savings in the stock market is thus important for stock market development in India. This is because stock market development and performance are affected by that corporate governance framework which provides adequate investor protection including effective grievance redressal mechanisms.[22] Corporate governance is also linked with stock returns, a phenomenon observed when companies give impetus to strong shareholder rights and thus bring about corporate democracy *i.e.,* power of shareholders to replace directors.[23] Investment in securities or rather the stock market is considered as the most attractive investment option because the investment can easily be converted into money through stock markets.[24] Especially in the light of liberalisation of the Indian

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[21] Rafael La Porta et al., *Investor protection and corporate governance*, 58 J. FIN. ECON. 3, 25 (2000) [hereinafter Rafael, *Investor Protection*].
[22] PARIMALA VELUVALI, RETAIL INVESTOR IN FOCUS: THE INDIAN IPO EXPERIENCE (2019).
[23] Gompers, *supra* note 14 at 48.
[24] Stock markets provide liquidity to investment in corporate securities. Investment can be made in different kinds of securities. The Securities Contracts (Regulation) Act,1956,

economy that heralded during the 1990s, it has been found that stock market liberalisations and developments have in fact led to increasing private funding and investment.[25] Private investments also increase when the investors are taken into confidence and there are better investor protection mechanisms in place. It is found that countries which focussed more on investor protection have also been able to develop their stock markets.[26] For example, countries rooted in common law tradition have been found to have laws catering to the protection of shareholders and creditors, thus resulting in stronger markets.[27] Investor protection is realised not only through good corporate governance mechanisms but also through well-written laws and regulations.[28] Laws and regulations against expropriation by insiders and deterring fraud and manipulation are essential concomitants of an effective legal system. It is of the foremost opinion that for securing investor protection and inducing the development of markets, utmost importance should be given to disclosure mechanisms. Disclosure is important for investors to invest in large numbers. As a market becomes more transparent, trust in the market also increases. The availability of accurate information is very essential for making sound investment decisions. Adequacy of disclosure is thus the cornerstone of a healthy capital and stock market. It is to be acknowledged that legislative reformation through the Companies Act, 2013, has been significant in promoting better corporate governance. To take note of a few of the instances where the Companies Act, 2013, has made a step ahead are the introduction of the 'small shareholders' under Explanation to Section 151. The Act enables the appointment of director elected by small shareholders. Further, Section 105, provides for the appointment of proxies for a

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s.2(h)(i) defines "securities" to include "shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate".

[25] Peter Blair Henry, *Do Stock Market Liberalizations Cause Investment Booms?*, 58 J. FIN. ECON. 301–334 (2000).

[26] Rafael La Porta et al., *Legal Determinants of External Finance*, 52 THE J. FIN. 1131–1150 (1997).

[27] *Id.*

[28] Rafael, *Investor Protection, supra* note 21 at 50.

member of a company, whereby the proxy can act as a substitute for the member and help in ensuring adequate participation to express the intention/wish of a member in a corporate decision-making process. The Companies Act, 2013, under Section 108, has also introduced E-Voting through electronic means as another step toward garnering more shareholder participation. It is not to be forgotten that many of the corporate governance norms have also been adhered to by companies to show their commitments to international standards. That is, when globalization of the capital markets necessitated better governance regimes, companies started adopting norms and procedures to make their securities more attractive to foreign investors. For example, it is important to appeal to the interests of institutional investors who are one of the most principal players in the market. Thus, measures by the capital market regulator to foster adherence to corporate governance norms are pivotal as it is the corporate governance system followed by a nation that ultimately paves way for a country's economic performance.[29]

E. RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FIRM VALUE

In corporate governance research, a common method used by researchers is to employ a corporate governance index and then assess whether the index forecasts firm value or performance. While one needs to be careful about the construction of an index using appropriate variables, the system is quite prevalent considering the fact that there are no good replacements for such research.[30] Corporate governance, a company's financial performance and firm efficiency are concepts which are inter-

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[29] Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 58 J. FIN. 737-783 (1997)..

[30] Antonio Gledson de Carvalho et al., *Corporate Governance Indices and Construct Validity*, THE HARV. L. SCH. F. CORP. GOV. (Oct. 17, 2016) https://corpgov.law.harvard.edu/2016/10/17/corporate-governance-indices-and-construct-validity/.

related. [31]A study of corporate governance employed by companies using index has shown that there is a positive linkage between corporate governance and firm performance and that better-governed firms exhibit better financial performance.[32] In India, it is found that developmental financial institutions and mutual funds had invested funds in companies that followed better governance practices.[33]Moreover, it has also been found that financial institutions have granted loans to companies with good governance records.[34] The empirical analysis also shows that there is an active connection between market capitalization, GDP growth and gross domestic saving, and better corporate governance and appropriate disclosures help in enhancing market discipline for ensuring transparency and greater accountability.[35]

The type of corporate governance mechanism followed has an outcome on the way the company nurtures its transactions and business with all stakeholders such as shareholders, creditors, employees, society as a whole etc.[36] Another feature that is strikingly peculiar for India is the ability of product market competition in acting as a complementing force to corporate governance. Product market competition is linked with financial performance and therefore managers strive to take the best decisions so that the firm does not end up with failures such as bankruptcy. This is because of the ability of product market competition in acting as an external disciplining order for corporate management.[37] Product market competition can aid in driving persistently inefficient firms out of the market acting as an ultimate discipline. However, for the Indian setting where product market competition is weak in many segments, mere

[31] Solomon Tadesse, *The Allocation and Monitoring Role of Capital Markets: Theory and International Evidence*, 39 THE J. FIN. AND QUANTITATIVE ANALYSIS 701–730 (2004).
[32] Pankaj Varshney et al., *Corporate Governance Index and Firm Performance: Empirical Evidence from India* (2012) https://papers.ssrn.com/abstract=2103462 (last visited Jan 13, 2021).
[33]*Id.*
[34] Pitabas, *Institutional Investors*, *supra* note 6 at 46.
[35] Naresh, *Estimation of Market Capitalization, supra* note 4 at 46
[36] Pitabas, *Institutional Investors*, *supra* note 6 at 46.
[37] Julia Chou et al., *Product Market Competition And Corporate Governance*, 1 TRIBOLOGY INT. 114–130 (2011).

emphasis on increasing product market competition as an equivalent to corporate governance of firms is not feasible, rather, good corporate governance reforms are effective.[38]

III. BOARD DIVERSITY IN IMPROVING CORPORATE GOVERNANCE

Board involvement and board diversity have found to be positively influencing firm performance.[39] Especially in emerging markets, board diversity has a significant value as there is a good quantum of diversification which is something typical of an emerging market firm.[40]Another important component necessary to derive benefits from Board diversity is having highly collegial groups which can create a better environment for productive work.[41] This is because of a sense of mutuality that arises from companionship and cooperation between directors who share the same responsibility. Hence, board diversity coupled with collegiality can ensure that consensus is reached on corporate decisions. Equally important is to achieve that diversity which encourages sharing of information and active consideration of alternatives in a decision-making process. Board diversity as a structural characteristic of the corporate board shows that diverse boards are connected to the stakeholders' interests and would be less likely to focus exclusively on short-term financial achievements.[42] As per certain

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[38] Ekta Selarka, *Corporate Governance, Product Market Competition and Firm Performance: Evidence from India*, CORPORATE GOVERNANCE IN EMERGING MARKETS: THEORIES, PRACTICES AND CASES 55–77 (2014)..

[39] Yogesh Chauhan et al., *Corporate Governance Practices, Self-Dealings, And Firm Performance: Evidence From India*, 12 J. CONTEMP. ACCOUNT. ECON. (2016).

[40] Shamsul N. Abdullah et al., *Does Having Women On Boards Create Value? The Impact Of Societal Perceptions And Corporate Governance In Emerging Markets*, 37 STRATEG. MANAG. J. 466–476 (2016).

[41] Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability* (2000).

[42] Igor Filatotchev et al., *Corporate Governance, Responsible Managerial Behavior, and Corporate Social Responsibility: Organizational Efficiency Versus Organizational Legitimacy?*, 28 AMP 289–306 (2014).

studies, it is found that exists a positive direct relationship between the overall board diversity and firm performance in India.[43]

To call a board effective it should have a well-balanced combination of capable board members who are well suited to the circumstances and specific needs of the company. This is the reason why boards propose new directors for election by shareholders.[44]As far as the efficiency of the management board is concerned, it is clear that the board must clearly understand the business of the particular corporation. Board effectiveness is an important characteristic of corporate governance.[45] There are certain crucial factors that determine the board effectiveness such as independence of the board, size and composition and these factors are to a great extent dependent on shareholder interests.[46] Board independence is directly linked to board composition.[47] The prevalent presumption is that more the number of outside directors, the more independent the board becomes. This is because the presence of outside directors assures impartial advice, objectivity in decisions, availability of new skills and different perspectives than insiders.[48] Another seminal question is what is the ideal board size? A good deal of literature points out that the size of the board and opportunities for growth of the firm are inversely related.[49] This is because it is practically difficult to reach a unanimous decision when there is a big board of directors due to conflicting opinions.

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[43] Demographic diversity index consisting of parameters of board gender, age, tenure, and education was studied, *See* Muneza Kagzi & Mahua Guha, *Does board demographic diversity influence firm performance? Evidence from Indian Knowledge Intensive firms*, 25 BENCHMARKING AN INT'L J. (2018) [hereinafter Muneza Kagzi & Mahua Guha].

[44] INSTITUTE OF DIRECTORS, THE HANDBOOK OF INTERNATIONAL CORPORATE GOVERNANCE: A DEFINITIVE GUIDE (2004) [hereinafter INSTITUTE OF DIRECTORS, DEFINITIVE GUIDE].

[45] Kose John et al., *Corporate Governance and Board Effectiveness* (1997).

[46] Kose John & Lemma W. Senbet, *Corporate Governance and Board Effectiveness*, 22 J. BANK FIN. 371–403 (1998)..

[47] *Id.*

[48] Ran Duchin et al., *When Are Outside Directors Effective?*, (2009).

[49] C. José García Martín & Begoña Herrero, *Boards Of Directors: Composition And Effects On The Performance Of The Firm*, 31 ECON. RES. -EKONOMSKA ISTRAŽIVANJA 1015–1041 (2018).

In a competitive environment, it is important that the board implements a standard of corporate governance that can nurture the kind of entrepreneurial culture that is appropriate to the nature of business the company is involved in.[50] The passiveness of the board coupled with its myopic vision can lead to short-termism and loss of shareholder value in the capital market and the reason why fallout on banks and financial institutions were witnessed in India in the first half of the twentieth century.[51] Strategic decisions require the competency of the board in the subject at hand. Wisdom, expertise and excellence in skills are effective instruments in the hands of the board of directors to bring about competitive benefits.[52] OECD suggests that directors with the right blend of background and competencies can improve the strategic guidance to the companies.[53] OECD also suggests that annual review of competencies and performance of board members, as well as the Board's functioning as a whole, is robust for effective board performance evaluation.[54] While some countries look into the qualifications of a board candidate, some other countries focus on the skills, expertise, experience, and knowledge on the board, and not on the individual qualifications of a member of the board. For example, in the United Kingdom, skills, experience, independence, and knowledge of the members on the board are looked into by the nomination committee as per the guidelines of the European Securities and Markets Authority ("**ESMA**") and the European Banking Authority.[55] In Singapore,

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[50] D. N. Ghosh, *Corporate Governance and Boardroom Politics*, 35 ECON. POLIT. WKLY. 4010–4014 (2000)..

[51] *Id.*

[52] Shamshuddin Nadaf & Bhimappa Navi, *Corporate Governance: Issues, Opportunities and Challenges* 3 INT'L J. COMM. MGMT. RES. 2455–1627 (2017).

[53] OECD, CORPORATE GOVERNANCE FACTBOOK, *supra* note 5 at 46.

[54] *Id.*

[55] EBA*, Joint ESMA and EBA Guidelines on the assessment of suitability of members of the management body and key function holders (EBA-GL-2017-12),* https://www.eba.europa.eu/sites/default/documents/files/documents/10180/1972984/43592777a5434a428d39530dd4401832/Joint%20ESMA%20and%20EBA%20Guidelines%20on%20the%20assessment%20of%20suitability%20of%20members%20of%20the

the Listing Manual requires directors to have appropriate experience and expertise to manage the group's business. Whereas in China independent board member candidates' qualifications are reviewed by the stock exchange as a listing requirement.

In India, the qualifications required of a director are discussed under Chapter XI of Companies Act, 2013, titled "Appointment and Qualifications of Directors" read with Companies (Appointment and Qualifications of Directors) Rules, 2014. While the due emphasis is given to qualifications of an independent director under the Companies Act, 2013,[56] there is not much statutory guidance on qualifications in the sense of education, skill and competency required of any other category of directors. This is in stark contrast to the jurisdictions discussed above. While it is left to the policies of companies in selecting desirable qualifications applicable to directors, it is found that there is a positive impact when Board members are highly educated with the technical know-how on new technology.[57] The experience of Board members can also increase efficiency and older directors bring valued knowledge that they gathered in the industry over years of practice.[58] Hence, there has been serious recommendations for the formation of corporate boards where members' education is also given importance.[59]

IV. BOARD INDEPENDENCE

Another characteristic of the Board which has a direct relation to firm performance is board independence. Board independence has a significant impact on firm value. Independence becomes a critical issue in determining the composition of any board as directors are fiduciaries of the shareholders

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%20management%20body%20and%20key%20function%20holders%20%28EBA-GL-2017-12%29.pdf?retry=1 (last visited Jan 23, 2022).

[56] The Companies Act, No. 18 of 2013, §149(6) (Ind.).

[57] Shital Jhunjhunwala & R.K. Mishra, *Board Diversity and Corporate Performance: The Indian Evidence* 11 IUP J. CORP. GOV. 71-79 (2012)..

[58] Ji Li et al., *Age diversity and firm performance in an emerging economy: Implications for cross-cultural human resource management*, 50 HUM. RESOURCE MGMT. 247–270 (2011).

[59] Muneza Kagzi & Mahua Guha*, supra* note 43 at 55.

and not of the management.[60] Directors are accountable only to the shareholders. The Board's independence is safeguarded by mechanisms that directors cannot be removed except by the shareholders at another general meeting.[61] A radical change has been brought about by the notification issued by SEBI dated 10.01.2020, whereby separation of the roles of the CEO and the Chairperson has been emphasized.[62] There is also splitting the role of Managing Director and Chairperson, as stipulated by the notification which shall provide a litmus test for good corporate governance in India.

When it comes to gender diversity, India introduced a compulsory quota of having at least one woman director on the board of directors in 2013.[63] As a result, the percentage of women on boards increased from 5.5% in 2010 to 12. 7% in 2017.[64] There are certain advantages of having women on board such as unique expertise, ability to objectify and women acting as natural mediators.[65] In addition to this, some studies observe that women tend to have a great deal of knowledge about consumer preferences as women are generally socially and community-minded in nature.[66] The presence of independent female directors has also found to have a positive influence on firm performance.[67] However, since in India, the statutory mandate requires only a minimum of a single independent director to be a

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[60] A. C. FERNANDO, CORPORATE GOVERNANCE: PRINCIPLES, POLICIES AND PRACTICES (2009).

[61] INSTITUTE OF DIRECTORS, DEFINITIVE GUIDE, *supra* note 44 at 55.

[62] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Gazette of India, pt. III sec. 4 (Jan. 10, 2020).

[63] The Companies Act, No. 18 of 2013, §149 (Ind.).

[64] Sarah Gordon & Kana Inagaki, *Asia's Lack Of Women On Boards Shows It Has Work To Do*, FIN. TIMES (May 11, 2017), https://www.ft.com/content/1b0d7abe-33ff-11e7-bce4-9023f8c0fd2e (last visited Nov 13, 2021).

[65] Jasmin Joecks et al., *Women Directors' Roles on Corporate Boards: Insights from a Qualitative Study* (2017)..

[66] Jyoti D. Mahadeo et al., *Board Composition and Financial Performance: Uncovering the Effects of Diversity in an Emerging Economy*, 105 J. BUS. ETHICS 375–388 (2012).

[67] Sudheer Reddy et al., *Board Gender Diversity, Family-Connected Directors and Firm Value* (2018)..

woman, and hence it is very unlikely that such a woman director alone would be able to drive significant corporate decisions on the board. Hence, there is a necessity to restructure the basis for independent directors for bringing about more independence on the board. [68] In India, the menace of cronyism in the appointment of Independent Directors was dealt with through Section 149 (6) of the Companies Act, 2013. A similar provision was recommended for the appointment of the women directors by the Kotak Committee report.[69]Another problem that can dilute the effectiveness of bringing in gender diversity through women's representation is when the same women are appointed to multiple boards, a trend known as 'golden skirts'.[70] Yet, studies on the women diversity bringing about participation on board is not statistically strong.[71]There have also been instances where women were instrumental in financial irregularities.[72]

Corporate Governance is the alignment of rights and responsibilities between different members in the corporation, such as the board, shareholders, managers and other stakeholders, and to bring about accountability to senior managers. This is also pertinent for creating rules and measures for making wise decisions on corporate affairs.[73] There is a lot of emphasis on corporate governance world-over because efficient

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[68] Akshaya Kamalnath et al., *Corporate Board Gender Diversity in the Shadow of the Controlling Shareholder – An Indian Perspective* (2018).
[69] KOTAK COMM., SEBI, REPORT OF THE COMMITTEE ON CORPORATE GOVERNANCE (2017), https://www.sebi.gov.in/reports/reports/oct2017/report-of-the-committee-on-corporate-governance_36177.html.
[70] Morten Huse, *The 'Golden Skirts': Lessons from Norway about Women on Corporate Boards of Directors*, DIVERSITY QUOTAS, DIVERSE PERSPECTIVES (2012).
[71] Kathleen A. Farrell & Philip L. Hersch, *Additions to corporate boards: the effect of gender*, 11 J. CORP. FINANCE 85–106 (2005).
[72] Chitra Ramkrishna, the former Chief Executive Officer (CEO) and Managing Director of National Stock Exchange (NSE) was arrested by Central Bureau of Investigation earlier this year in relation to unfair practices of leaking important and confidential information of NSE to a spiritual guru. Another instance is that of Chanda Kochhar, the former managing director and chief executive officer of ICICI Bank being involved in money laundering and the Enforcement Directorate lodged a case against her.
[73] D. N. Ghosh, *Corporate Governance and Boardroom Politics*, 35 ECON. POLIT. WKLY 4010–4014 (2000).

corporate governance enhances investor confidence bringing about firm value maximisation.[74] This is also important for long-term success and standing of the firm. In addition to this, it is found corporate governance promotes national governance, human governance, societal governance etc.[75]Particularly in the context of globalisation when markets are merging internationally, the significance of corporate governance cannot be undermined.

V. CORPORATE SECURITIES FRAUDS AND PREVENTION

Non-adherence to ethical behaviour and violation of code of conduct, or better yet, failure of corporate governance is attributable to the failure of corporate governance.[76] A failed corporate governance environment is a nurturing ground for frauds. In fact, the topic of corporate governance has gained so much attention because of the myriad ways in which fraud has been undertaken in the stock market. N.R. Narayana Murthy, founder of Infosys states that *capitalism with integrity* is the key principle for corporate governance.[77]

Securities fraud is in fact securities market fraud. Some scholars consider securities fraud as the result of behavioural delinquency. Here fraud is understood as a lack of a company's commitment to market integrity and therefore misconduct behaviour creates a significant loss to

[74] Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Performance* (2004), https://papers.ssrn.com/abstract=586423 (last visited Apr 27, 2022).
[75] The Institute of Company Secretaries of India, *Governance, Risk management, Compliances and Ethics* (2019), https://www.icsi.edu/media/webmodules/GOVERNANCE_RISK_MANAGEMENT_COMPLIANCES_AND_ETHICS.pdf (last visited Oct 12, 2021).
[76] Supreena Narayanan, *Financial Market Regulation-Security Scams In India with historical evidence and the role of corporate governance,* ECON PAPERS (2003), https://econpapers.repec.org/paper/wpawuwpfi/0310006.htm.
[77] Narayana N.R. Murthy, *Corporate Governance and its Relevance to India*, 38 INDIA INT'L CENTRE QUARTERLY 280–288 (2011).

shareholders and all stakeholders, such as creditors, customers, and suppliers, which may activate regulatory enforcements.[78] A few varieties of securities fraud include misstatements on financial reports of public companies, stock price manipulation, skimming of accounts, etc.

The world's largest anti-fraud organization, the Association of Certified Fraud Examiners ("**ACFE**") states that, *"Fraud by its very nature, does not lend itself to being scientifically observed or measured in an accurate manner. One of the primary characteristics of fraud is that it is clandestine, or hidden; almost all fraud involves the attempted concealment of the crime."*[79]

Securities fraud is democratic as its destruction is widely distributed and shared by all. Thus, the deleterious effects of fraud in the market will be felt for a long time. Restoring the investors back to the original position is also difficult. For example, in ***Securities Exchange Board of India v. Sahara India Real Estate Ltd.***,[80] the Supreme Court directed the delinquent companies forming part of the Sahara group to refund around Rs 17,400 crore to the investors within 3 months from the date of the passing of order together with an interest at the rate of 15%. SEBI toiled for more than nine years to oversee a refund of Rs. 129 crore to investors while the amount deposited in specially-opened bank accounts inflated above Rs. 23,000 crore.[81]

A fair and efficient securities market is one of the hallmarks of the economic growth of a country. The regulatory framework in India for curbing securities fraud is continuously evolving. The capital market

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[78] Xiaoyun Yu, *Securities Fraud and Corporate Finance: Recent Developments*, 34 MANAGERIAL AND DECISION ECON. 439–450 (2013).

[79] ACFE, REPORT TO THE NATIONS: 2020 GLOBAL STUDY ON OCCUPATIONAL FRAUD AND ABUSE (2020).

[80] Securities Exchange Board of India v. Sahara India Real Estate Ltd (2013) 1 SCC 1 (Ind.).

[81] *Sebi's refund to Sahara investors inches up to Rs 129 crore; balance in repayment accounts swells to Rs 23,000 crore*, THE TIMES OF IND. (Aug. 5, 2021), https://timesofindia.indiatimes.com/business/india-business/sebis-refund-to-sahara-investors-inches-up-to-rs-129-crore-balance-in-repayment-accounts-swells-to-rs-23000-crore/articleshow/85068173.cms.

regulator under Section 11 of the SEBI Act, 1992, is armoured with the primary objectives of investor protection and promotion and regulation of the securities market. To this end, SEBI has always taken various measures to curb market manipulation arising from securities frauds and ensure fair market conduct. The changing landscape of financial services due to technological innovations and the rapid flow of information calls for aggressive steps in surveillance and detection of securities fraud and enforcement to curb market abuse. For example, SEBI has in its report to the Committee on Fair Market Conduct, acknowledged the nuances of High-Frequency Trade using opaque algorithms for trading and suggested measures to curb manipulation associated with the price and volume of stocks.[82] The means to achieve fair market conduct are varied and include measures such as insistence on following ethical and statutory rules, corporate governance, and also by prohibiting, preventing, detecting, and punishing market conduct that lead to 'market abuse'. Market abuse includes market manipulation, insider trading, and all such fraudulent activities that erode investor confidence and impairs economic growth.

The task of preventing securities fraud is difficult due to a variety of reasons. First and foremost, for any regulation to be effective, the pre-requisite of definitional clarity cannot be undermined. Moreover, opaqueness on what is being prohibited and deterred aggravates the problem. Another point of concern is to determine what are the policy considerations for the regulator in initiating a prosecution. There is also a selection problem with respect to the remedies to be pursued when both avenues of civil and criminal litigation are available under the very same legislation. For example, in the scheme of the Securities and Exchange Board of India Act, 1992, Section 24 provides the jurisdiction to the Board to set the criminal law into motion without prejudice to the award of a

[82] SECURITIES AND EXCHANGE BOARD OF INDIA, GOV'T OF IND., Report of Committee on Fair Market Conduct for public comments (2018), https://www.sebi.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html.

penalty by the adjudicating officer.[83] Therefore, there is always a question of whether the public expectation is met as to the regulatory proceedings initiated as the public may anticipate a criminal prosecution whereas the regulator may only have taken action with civil consequences.

Examining the issue of definitional clarity, it is found that currently, the securities legislations provide an unclear picture from the undefined concepts. This was the exact comment given by the Supreme Court in ***SEBI v. Kanaiyalal Baldevbhai Patel***[84] when the Court struggled to fix liability on a non-intermediary in front running under the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 ("**PFUTP Regulations**"). Regulation 2(c) thereof is falling short of the doctrinal underpinnings of fraud as a morally charged concept both under civil and criminal law.[85] While defining 'fraud' Regulation 2(c) expresses "whether in a deceitful manner or not."[86] This is in contradiction to the evolution of fraud from developments in common law when deceit being an intentional tort was recognized as early as 1789 in ***Pasley v. Freeman***.[87]In addition to this definitional lack of preciseness, the PFUTP Regulations do not stress the importance of harm caused. It is interesting to see that intention of deceit is however stressed in Section 447 of the Companies Act, 2013,

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[83] Securities and Exchange Board of India Act, 1992, Section 24. Offences—
(1) Without prejudice to any award of penalty by the adjudicating officer under this Act, if any person contravenes or attempts to contravene or abets the contravention of the provi-sions of this Act or of any rules or regulations made thereunder, he shall be punishable with imprisonment for a term which may extend to ten years, or with fine, which may extend to twenty-five crore rupees or with both.
(2) If any person fails to pay the penalty imposed by the adjudi-cating officer or fails to comply with any of his directions or orders, he shall be punishable with imprisonment for a term which shall not be less than one month but which may extend to ten years or with fine, which may extend to twenty-five crore rupees or with both.
[84] SEBI v. Kanaiyalal Baldevbhai Patel, (2017) 15 SCC 1 (Ind.).
[85] Jayme Hersch Kopf, *Morality And Securities Fraud*, 101 MARQ. L. REV. 453 (2017).
[86] See that under Section 447 of the Companies Act, 2013, fraud is a cognizable, non-bailable, non-compoundable offence. The Serious Fraud Investigation Office(SFIO) constituted under Section 211 can be assigned with investigation by the Central Government in matters of serious fraud.
[87] Pasley v. Freeman (1789), 3 T. R. 51.

which provides for punishment for fraud. On the count of public interest as being served as a quintessential function of the regulator in proceeding with market fraud, one can understand the dissatisfaction of the public when public interest litigation was filed in the Madras High Court as SEBI dismissed all charges levelled against the National Stock Exchange ("**NSE**") in the NSE co-location matter.[88] The petition alleged impropriety in the SEBI order as the regulator had dismissed all charges against NSE. The petition alleges that the NSE has violated the fundamental objective inside the trading and given illegal/preferential access to certain Trade Members ("**TMs**").[89]

Prevention also requires insight and there are three important conventions to be followed to understand how to prevent: know the definitions and descriptors, know the perspectives and products and know the rules and resources.[90]Another reason why fraud prevention is difficult is because of the partial observability problem, *i.e.,* one observes only those frauds that have been committed and subsequently detected.[91]The probability of the fraud detected is also the result of two latent events *i.e.,* fraud commission and fraud detection.[92] Predictability of fraud is almost impossible for law enforcement officials by merely relying on *ex-ante* characteristics. For example, it is a good audit practice to monitor in-depth when a company presents inflated accounts. In the Sathyam scam, the accounts were inflated, yet, the enforcement failed to detect anything fishy until the time when Ramalinga Raju himself revealed of falsification of accounts. On the other hand, an evaluation of *ex-post* parameters usually shows a decline in firm performance which by itself does not aid in fraud

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[88] SEBI final order in WTM/GM/EFD/02/2019–20 and WTM/GM/EFD/03/2018-19.
[89] *See,* order of the Madras High Court in WP.No.28493 of 2019 and WMP.Nos.28212 and 28414 of 2019.
[90] LOUIS STRANEY, SECURITIES FRAUD: DETECTION, PREVENTION AND CONTROL (2010).
[91] Tracy Yue Wang, *Corporate securities fraud: Insights from a new empirical framework*, 29 J. LAW ECON. ORGAN. 535–568 (2013)
[92] *Id.*

detection. However, a discussion on fraud detection and prevention strategy is important considering the fact that it is none other than the perpetrator who initially measures the cost-benefit analysis of the fraud before anyone does.it is for this reason that some of the same factors that inspire a perpetrator to commit fraud are likely to be present in the stages of detection and prevention of the fraud. A seminal study through Cressey's Hypothesis formulated as early as 1953 through his book '*Other People's Money: A Study in the Social Psychology of Embezzlement*'' paved the way for some concrete studies on understanding the factors in committing fraud to enable fraud detection and prevention. The famous 'Fraud Triangle' came to be laid down through this study.[93]Cressey called the fraudsters 'trust violators.' He studied the circumstances that led them to overcome temptation and indulge in fraud without remorse.

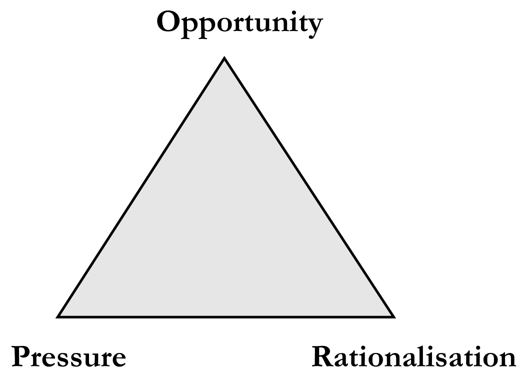

Figure 2:Fraud Triangle

Explaining the 'pressure' aspect of the triangle, Cressey stated that it constituted 'Non-sharable Problems' of the offender such as violation of ascribed obligations *i.e.,* inability to pay debt; problems resulting from personal failure; a need for status gaining in an organisation; employer-

[93] Donald R. Cressey was working on his doctorate in criminology, and visited prisons to interview about 200 inmates. Cressey in his work did not name the Fraud Triangle and it was scholars that followed up his study making adaptations of the same, who named it as the 'Fraud Triangle'.

employee relations etc. The difficulty in predicting the 'non-shareable problems' is that it is subjective. The mindset of the perpetrators showed that there was 'rationalisation' *i.e.,* they were ready to excuse their actions by viewing their violations as an outcome of either of the three factors- *firstly* noncriminal, *secondly* justified and *lastly* as part of an uncontrollable situation. The third aspect in the triangle, a perceived 'opportunity' to commit and conceal the dishonest act furthers the inclination to undertake the violation. While the legs of the triangle explore the antecedents of fraud, the outcome of this study shows that there are certain red flags or specific indicators representing potential fraud occurrences in the market.[94]For example, compensation patterns like failure to receive an expected promotion stimulate management to commit fraud.[95]Since the ways of fraud commission are infinite,[96]it is important for a firm to lay down clear policies of conduct that is prohibited.[97]However, the Cressey model is with limitations as academicians who have applied this model suggests that it is not fully useful in developing an appropriate fraud prevention strategy.

Apart from the pioneering work of Cressey, modifications of the Fraud Triangle have been presented by later scholars. Louis L. Straney through his abundant experience as a senior manager in the financial services industry has shown in his book how a three-dimensional Fraud

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[94] Deepa Mangala et al., *Corporate Fraud Prevention and Detection: Revisiting the Literature*, 4 J. COMM. AND ACC. RES. (2015); *See also,* DEEPA MANGALA & POOJA KUMARI, *Red Flag: A Mean for Preventing and Detecting Corporate Fraud* (2015), https://papers.ssrn.com/abstract=2988594.

[95] Carol M. Jessup, *Fraud Insights Derived from Stories of Auditors of Financial Institutions*, 4 JFIA (2012).

[96] An interesting description on structural conception of fraud is seen through the passage of Letter of Lord Hardwicke to Lord Kames, dated June 30, 1759, printed in Parkes, History of the Court of Chancery (1828), 508, quoted in Snell, Principles of Equity (25th ed. 1960), 496, "Fraud is infinite, and were a court of equity once to lay down rules, how far they would go [...] or to define strictly the species or evidence of it, the jurisdiction would be cramped, and perpetually eluded by new schemes, which the fertility of man's invention would contrive."

[97] DR. JOSEPH T. WELLS, CORPORATE FRAUD HANDBOOK (5th ed. 2017).

Triangle, as opposed to two- dimensional Fraud Triangle of Cressey's, can help in better understanding the incidences of securities fraud. Straney has identified a major fourth attribute in the context of securities fraud, to call it in his own words, *'a self-appointed sense of entitlement'* in committing the fraud which is the outcome of greed and deception.

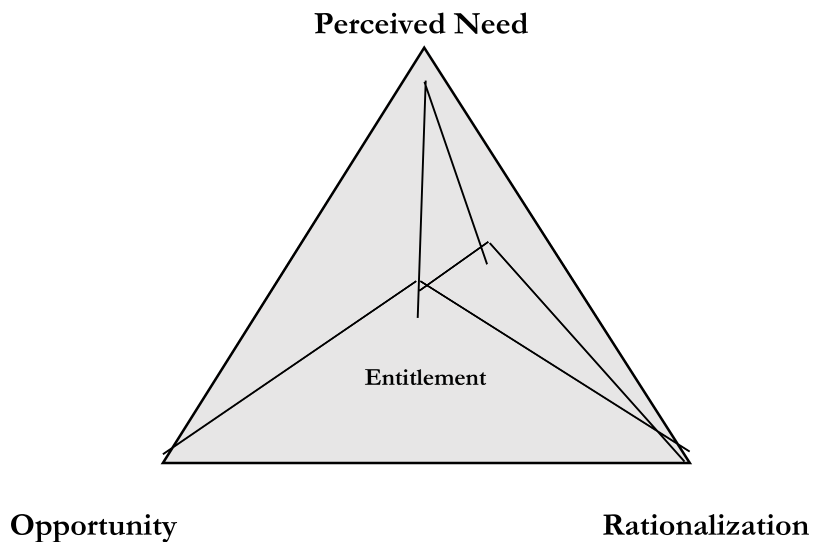

Figure 3: Fraud Triangle re-considered by Louis L. Straney

Another pioneering work was that of Steve Albrecht who developed the 'Fraud Scale'. On a gauge of low to high, one can see the movement of a needle on a hypothetical scale through the components of situational pressures, perceived opportunities, and personal integrity. However, Albrecht himself had warned that it is hard to profile the perpetrators and predict fraud using this scale. Another widely discussed model is the "Fraud Diamond'. Wolfe and Hermanson, in addition to the factors of incentive, opportunity, and rationalization, added a fourth factor *i.e.,* an individual's capability which includes his personal traits and abilities.[98] While there are

[98] David T Wolfe & Dana R Hermanson, *The Fraud Diamond: Considering the Four Elements of Fraud*, THE CPA J. 6 (2004).

many more models and theories aiding to identify factors responsible for fraud commission, neither of any of them will give a fit all situations scenario.[99] This is because as already explained, the ways of fraud are infinite.

VI. SUGGESTIONS

The Companies Act, 2013, have ushered in new measures for improved corporate governance such as the vigil mechanism for public companies under Section 177 encouraging whistle blowing and protection of persons against victimization who report irregularities.[100] There is a further need to strengthen the vigil mechanism by forming sub-committees to look into investor grievances on a regular basis. It is also important as part of ethical and sustainable practices for corporations to identify symptoms of systemic failures and the red flags for early detection and prevention of fraud. Adoption of preventive techniques such as having in place well drafted anti-corruption policy which details that even acceptance of gifts from customers, clients and creditors are unacceptable as per the Corporate Governance standards of the firm; adoption of schemes to counter situations of conflict of interest *i.e.,* ensuring that a fiduciary, agent, or employee always act in good faith with full and material disclosure and that too in the best interest of the firm are a few of the measures that can go in

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[99] Ramamoorti (2008) developed ABC model where A stands for the Bad Apple *i.e.,* individual personality characteristics of a perpetrator; B stands for the Bad Bushel *i.e.,* group dynamics of collusive behaviour and C stands for the Bad Crop *i.e.,* the societal factors that enable commission of fraud.

[100] The Companies Act, 2013, Section 177- Audit Committee

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(9) Every listed company or such class or classes of companies, as may be prescribed, shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed.

(10) The vigil mechanism under sub-section (9) shall provide for adequate safeguards against victimisation of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases: Provided that the details of establishment of such mechanism shall be disclosed by the company on its website, if any, and in the Board's report

a long way in enhancing corporate accountability. It is always important to anticipate and take pre-emptive steps in adherence to a good corporate governance framework to ensure fairness in dealings rather than counter corporate fraud as a knee-jerk reaction. Another important step the regulator can ensure is having in place well-delineated laws that define fraud with clarity. This can go a long way in aiding the judiciary to enforce the law, rather than grappling with the issue using tools of interpretation. While faith, hope and charity are considered the three important parts of religion, there are similarly three important parts of corporations - business ethics, corporate governance and social responsibility.[101] The SEBI have been continuously aiming to improve the regime of corporate governance in India as an answer to fraud prevention and detection. On the Environment Social & Governance ("**ESG**") front, SEBI insists on a mandatory 'Business Responsibility and Sustainability Reporting' (BRSR)by listed entities from FY 2022-23.[102] Under the BRSR, there is a consideration of quantitative and standardized disclosures on ESG parameters where corporate governance-related disclosures include an assessment of the role of the management board in achieving sustainability. It is expected that such innovative mechanisms can help track firm performance through the lens of Corporate Governance principles and thus aid in the early detection and prevention of securities market fraud.

VII. CONCLUSION

The study presents that enforcement of good corporate governance proves beneficial on various fronts such as firm performance, economic development, aligning with international standards, attracting investments, improving efficiency etc. The importance of good corporate governance practices also cannot be understated in the light that effective monitoring increases the chance that fraudulent activities get uncovered and larger

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[101] E. K. SATHEESH et al., CORPORATE GOVERNANCE: PRINCIPLES, POLICIES AND PRACTICES (3rd ed. 2018).

[102] SEC. & EXCH. BD. IND., CIRCULAR FOR BUSINESS RESPONSIBILITY AND SUSTAINABILITY REPORTING BY LISTED ENTITIES, SEBI/HO/CFD/CMD-2/P/CIR/2021/562.

institutional ownership is related to a higher likelihood of fraud detection because of the specific synergies that it can bring to the board.[103]The dynamics of the board and its fairness has a significant part to oversee that instance of fraud are prevented. In the matter of *Tata Consultancy Services,*[104]it was laid down by the Hon'ble Supreme Court of India that *"corporate democracy is genesis and corporate governance is species and with the coming into force of the Companies Act, 2013, law has moved from 'corporate majority' or 'corporate democracy' to 'corporate governance'."* Every action of the Board has to pass the test of fairness. It is also known that the obligations of the directors in listed companies are particularly onerous.[105] Evidence shows that mismanagement and compromise in corporate governance norms and risk management results in fraud.[106]Judicial activism has also provided the much-needed impetus to oversee the implementation of corporate governance practices. The Court in regulating the auditing profession of Multi-National Accounting Firms in India, in the light of 'Corporate Audit and Governance' directed the Union of India *"to constitute a three-member committee to look into need for an appropriate legislation on the pattern of Sarbanes Oxley Act, 2002 and Dodd Frank Wall Street Reform and Consumer Protection Act, 2010 in US or any other appropriate mechanism for oversight of profession of the auditors."*[107] The Hon'ble Supreme Court upheld the importance of corporate governance when it categorically stated that the Serious Fraud Investigation Office is empowered to identify non-compliance of the Corporate Governance.[108] Active reactions and deterring orders of debarment and penalty shows that the regulator has reiterated the roles of intermediaries in an initial public offering in discharging duties as

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[103] Andrei Shleifer et al., *A Survey of Corporate Governance*, 52 J. FIN. 737–783 (1997).

[104] Tata Consultancy Services Limited v. Cyrus Investments Pvt. Ltd. and others, (2021) 9 SCC 499 (Ind.).

[105] N. Narayanan v. Adjudicating Officer, (2013) 12 SCC 152 (Ind.).

[106] Hari Sankaran v. Union of India (UOI) and Others, (2019) 6 SCC 584 (Ind.).

[107] S. Sukumar and Others v. The Secretary, Institute of Chartered Accountants of India and Others, (2018) 14 SCC 360 (Ind.).

[108] Serious Fraud Investigation Office v. Rahul Modi and Another, (2019) 5 SCC 266 (Ind.).

repositories of trust, integrity and skill and therefore when they disregard the statutory 'Code of Conduct', it is not a minor aberration. For example, in ***SEBI v. Karvy Stock Broking Ltd***.,[109] the order of SEBI in fixing liability for fraud and manipulation in opening fictitious Demat accounts, 'afferent accounts' stated that,

"Law of Evidence, the presumption of innocence is no doubt presumption juris; but everyday practice shows that it may be successfully encountered by the presumption of guilt arising from circumstances, though it may be a presumption of fact. Since it is exceedingly difficult to prove facts which are especially within the knowledge of parties concerned, the legal proof in such circumstances partakes the character of a prudent man's estimate as to the probabilities of the case."

[109] SEBI and Others v. Karvy Stock Broking Ltd., 2007 73 SCL 261 SAT (Ind.).

THE RISING INCIDENCE OF NPAS IN INDIA: DO WE NEED GREATER TRUSTEESHIP IN FINANCIAL CORPORATE GOVERNANCE?

*Varsha S Banta**

ABSTRACT

*The Indian debt financing ecosystem is ever-evolving. Under the 2022-23 union budget ("**Union Budget**"), the Indian finance ministry ("**Finance Ministry**") proposed among others, (i) greater private sector investments;[1] (ii) improving credit availability for emerging sectors such as digital infrastructure and clean energy;[2] and (iii) enhanced credit assistance for micro, small and medium enterprises.[3] However, one of the subsisting challenges to efficient credit cycles is that of unacknowledged leakages, inadequate returns, and protracted recovery cycles. The challenge that banking institutions, and specifically public sector banks ("**PSBs**") face, is that of non-performing assets ("**NPAs**"), which despite oversight and internal procedures, may still manifest within the real economy. The present-day NPA problem, occurring either in the form of automatic or wilful defaults, is the culmination of (i) structural microeconomic; and (ii) systemic factors, leading ultimately to a cycle of bad loans. This paper will focus on regulatory norms and activities affected by systemic factors and will aim to revisit corporate governance standards through an economic analysis. In the above context, this paper will use agency law; and suggest corporate governance reforms through the confluence of regulatory and governance strategies, with a specific focus on the trusteeship system.*

Keywords: Non-performing asset, Public Sector Banks, Corporate Governance.

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1 Ms. Nirmala Sitharaman, *Speech Budget 2022-2023* (Feb. 1, 2022) https://www.indiabudget.gov.in/doc/budget_speech.pdf.

2 *Id.* at 18.

3 *Id.* at 7.

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I. INTRODUCTION

The Indian economic landscape continues to expand its contours and sectoral diversity. With rising opportunities in several industries, particularly infrastructure, mining, and textiles, capital infusion continues within the Indian economy. In a report titled *Global Economic Prospects,* the World Bank has predicted that the Indian economy is set to grow at a rate of 8.3% (eight-point three percent) in the fiscal year 2021-22.[4] These projections may presuppose, of course, certain enabling circumstances to sectoral investments. These might include regulatory certainty, equitable allocation of invested funds, and, more importantly, efficient asset performance, i.e., adequate, and timely returns on investment.[5]

However, one of the primary challenges to lucrative lending exists predominantly within the financial sector's prior assessment and tracking systems. The challenge that banking institutions, and specifically public

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[4] World Bank, *Global Economic Prospects*, 4 (2021), https://www.worldbank.org/en/publication/global-economic-prospects.

[5] Rajiv Ranjan & Sarat Chandra Dhal, *Non-Performing Loans, and Terms of Credit of Public Sector Banks*, 24(3) RES. BANK OF IND. OCCASIONAL PAPERS 81, 108, https://rbidocs.rbi.org.in/rdocs/publications/pdfs/60613.pdf.

sector banks face is that of NPAs. NPAs have been defined by the Reserve Bank of India ("**RBI**") as an asset, including a leased asset that becomes non-performing when it ceases to generate income for the bank.[6] Further, it may be a loan or advance having any or all the characteristics listed below:[7]

- interest and/ or instalment of the principal amount remains overdue for a period of more than 90 (ninety) days in respect of a term loan;
- the account remains 'out of order', that is the outstanding balance remains continuously in excess of the sanctioned limit/drawing power for 90 (ninety) days;
- the bill remains overdue for a period of more than 90 (ninety) days in the case of purchased and discounted bills;
- the instalment of principal or interest payable remains overdue for 2 (two) crop seasons for short duration crops;
- the instalment of principal or interest thereon remains overdue for 1 (one) crop season for long duration crops;
- the amount under the liquidity facility remains outstanding for more than 90 (ninety) days, in respect of a securitisation transaction undertaken; and/or
- the overdue receivables representing the positive market-to-market value of a derivative contract remain unpaid for a period of 90

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[6] Reserve Bank of India, Master Circular- Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to the Advances Portfolio, RBI/2022-23/15 (Issued on Apr. 1, 2022).

[7] Reserve Bank of India, Master Circular- Income Recognition, Asset Classification, Provisioning and Other Related Matters – UCBs, RBI/2022-23/17 (Issued on Apr. 1, 2022).

(ninety) days from the specified due date for payment, in respect of derivative transactions.[8]

NPAs may arise due to automatic or wilful defaults.[9] Subsequent to such defaults corporations may tend to seek further loans to stay afloat; however, the possibilities of receiving additional credit are open to adverse impacts due to poor credit ratings and prior defaults.[10] Further, unethical, and unlawful practices undertaken by bank management, along with malleable credit assessment mechanisms, may encourage unwarranted flexibility on norm adherence while reviewing loan requests.[11]

This flexibility may be guided by a wide range of factors such as (i) the inadequacy of internal regulations; (ii) payoffs to lenders in exchange for loan approvals; and/or (iii) subversion of the credit rating process. These factors are often a consequence of the overlapping interests and sense of familiarity between lenders and borrowers.

Accordingly, regulators have enacted statutes and issued directions to tackle surmounting debt (as inefficient assets). The RBI has introduced several progressive reforms such as the Insolvency and Bankruptcy Code, 2016 ("**IBC**")[12], and The Recovery of Debts Due to Banks and Financial Institutions Act, 1993,[13] among other debt recovery mechanisms that aim to achieve expedient debt resolution. However, it may be noted that despite these statutes, tackling the challenge itself may be delayed until banks classify a particular asset as non-performing, a common challenge known

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[8] Reserve Bank of India, Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, RBI/2009-10/39 (Issued on Jul. 1, 2009).

[9] Reserve Bank of India, Master Circular on Wilful Defaulters, RBI/2014-15/73 (Issued on Jul. 1, 2014).

[10] Lawrence J. White, *Credit Rating Agencies: An Overview*, 5 ANN. REV. FIN. ECON. 93,122 (2013).

[11] Steven Scalet & Thomas F. Kelly, *The Ethics of Credit Rating Agencies: What Happened and The Way Forward*, 111 J. BUS. ETHICS 477,490 (2012).

[12] Insolvency and Bankruptcy Code, No. 31 of 2016 (Ind.).

[13] The Recovery of Debts Due to Banks and Financial Institutions Act, No. 51 of 1993 (Ind.).

as *ever-greening,*[14] or the indefinite postponement of debt resolution.[15] Technically, *ever-greening* refers to the banking practice of *managing* the balance sheet through means, which may not be violating banking laws in the letter but breaching them in spirit.[16]

In essence, such breach by banks could mean employing funds non-judiciously and often to the extent of creating (i) future costs for shareholders in terms of potential debt recovery litigation and other proceedings; and (ii) present sunk costs for banks themselves owing to low, or even nil returns (repayments) on loans extended.

However, *ever-greening* is not a one-sided phenomenon; its stagnation effects on banks may decrease liquidity for both borrowers as well, leading to the *twin balance sheet problem*. The *twin balance sheet* problem refers to the rise of excessive asset provisioning witnessed primarily by banks and infrastructure companies in India, 2 (two) decades ago.[17] Scholars have argued that India may now face a *four-balance sheet problem*, additionally encompassing real estate companies and non-banking finance companies, outside of the traditional lender-borrower (bank-customer) binary.[18]

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[14] Reserve Bank of India, Prudential Framework for Resolution of Stressed Assets, RBI/2018-19/203 (Issued on Jun. 7, 2019); *See also*, Reserve Bank Of India, Covid19 Regulatory Package – Review Of Resolution Timelines Under The Prudential Framework On Resolution Of Stressed Assets, RBI/2019-20/219 (Issued on Apr. 17, 2020).

[15] Professor Raghuram G. Rajan, *Note to Parliamentary Estimates Committee on Bank NPAs*, THE HINDU BUS. LINE, https://www.thehindubusinessline.com/money-and-banking/article24924543.ece/binary/Raghuram%20Rajan%20Parliamentary%20note%20on%20NPAs.

[16] Banking Bureau, *RBI warns on 'evergreening',* BUS. STANDARD (Feb. 6, 2013), https://www.business-standard.com/article/finance/rbi-warns-on-evergreening-104032201006_1.html.

[17] Arvind Subramanian & Josh Felman, India's Great Slowdown: What Happened? What's The Way Out? (Harv. Kennedy Sch., CID Faculty, Working Paper No. 370, 2019), https://www.hks.harvard.edu/sites/default/files/centers/cid/files/publications/faculty-working-papers/2019-12-cid-wp-369-indian-growth-diagnosis-remedies-final.pdf.

[18] *Id.*

The testimonies to this phenomenon may be found within multi-party (consortium) lending, for instance, the ***Kingfisher Insolvency case***,[19] which witnessed a unique blend of over-leveraging, rapid changes in corporate structure, external/sectoral factors, such as rising overheads (among others, fuel prices).[20]

Therefore, drawing from the background of the ***Kingfisher Insolvency case***, effective NPA regulation becomes even more significant when concerning larger entities that may hold sway over rival firm conduct. Even the most incisive regulations may need practical support to tackle market effects in monopolistically competitive industries, such as aviation.

In addition to the above reasons as to why borrowers fail to repay loans, either due to inability or unwillingness, there are a few standard factors that may lead to NPAs. The RBI's former governor, Professor Raghuram G. Rajan has noted a few of these to be (i) lender over-optimism; (ii) slow (economic) growth; (iii) regulatory approvals; (iv) loss of promoter and banker interest; (v) malfeasance; and (vi) fraud.[21]

However, the specific query that must be answered is this, "why revisit corporate governance standards through an economic lens, and not through that of banking regulations itself?" In a normative sense, this analysis is necessary because we need a more refined economic analysis of the law, owing to the homogeneity of the fiscal and legal environment we find ourselves in today. Particularly, we require an analysis of the law of contract; and further of contracts of agency, typically those involving multiple principals. This will, therefore, require a more nuanced analysis of the governance of commercial contracts. Nonetheless, what an economic analysis might do is offer an approximation of the costs of a breach of

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[19] State Bank of India and Others v. Kingfisher Airlines Ltd. And Others, I.A. Nos. 9-12, 13-16, 1-4 of 2016 and Contempt Petition (C) Nos. 421-424 of 2016 in SLP (C) Nos. 6828-6831 of 2016 (Ind.).

[20] *Id.*

[21] *Supra* note 14.

agency breach, which may compound exponentially over time if left unaddressed.

Additionally, such an analysis may offer approximations of opportunity costs, illustrative of the benefit foregone (returns, or repayment that a principal, or lender may not receive from the credit extended) due to the said breach.[22] While the breach is *ultra vires* in law*,* qualification through contractual terms may facilitate an understanding of the extent and nature of the costs borne.[23] This article is structured as follows:

Part II will review the learnings of three significant banking and corporate governance failures, being *Enron* and *WorldCom* in the United States and the Punjab National Bank ("**PNB**") case in India.

Part III will delve into the challenge of the agency problem and of 'rogue agents' within the banker (agent) and shareholder/stakeholder (principal) relationship.

Part IV will broadly set out the Indian banking governance regime, including the framework established by the Ministry of Corporate Affairs ("**MCA**"), RBI, and the Securities and Exchange Board of India ("**SEBI**").

Part V will explore the contours of the 'agency problem' viz. external sub-agents, such as credit rating agencies ("**CRAs**"), along with relevant SEBI regulations.

Part VI will discuss the interplay of the lending risk and reward (i.e., incentive - compensatory or otherwise) for banking executives.

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[22] Louis Kaplow & Steven Shavell, *Economic Analysis of the Law*, HARV. L. SCH. (2002), http://www.law.harvard.edu/faculty/shavell/pdf/99_Economic_analysis_of_law.pdf.
[23] Ham Willburt D., *Ultra Vires Contracts Under Modern Corporate Legislation*, 46 KENTUCKY L. J. 215-249 (1957).

Part VII will discuss global statutory and reporting reforms which followed banking governance failures, under the *Sarbanes-Oxley Act*, *2002* ("**SOX**") (in the United States) along with the Prevention of Corruption Act, 1988 ("**PoCA**"), and Prevention of Money Laundering Act, 2002 (in India).

Part VIII and **Part IX** will set out concluding remarks, and recommendations, respectively.

II. WHAT CAN BANKING FRAUD TEACH US?

History repeats itself, and at times, in greater degrees. The global meltdown of 2007-2008 is considered by many economists to have been the gravest financial crisis since the Great Depression of the 1930s.[24] Its origin, however, is said to have begun in the United States, where banks were engaging in *securitization* after a series of bad loans – a practice that involved packaging together differently valued mortgages and diversifying their risk components.[25]

These mortgages were marketed as *subprime loans* in the United States housing market to consumers with low credit ratings; in other words, to borrowers with inadequate collateral, and therefore low repayment capacity.[26] Bankers assessed the numerous mortgaged houses and concluded based on their sheer volume, that they were assets with potential.[27] In a nutshell, it was a dangerous combination of inadequate risk analysis and aggressive risk-taking that many believe caused the economic crash.[28] Scholars argue that primarily 3 (three) factors encouraged financial institutions to engage in aggressive risk-taking, characterized namely by (i)

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[24] Thilo Albers & Martin Uebele, The Global Impact of the Great Depression (Econ. His. Working Papers, Paper No. 218, 2015), https://eprints.lse.ac.uk/64491/1/WP218.pdf.
[25] RAGHURAM RAJAN, FAULT LINES, 6-8, (Collins Business 2010).
[26] *Id.*
[27] *Id.*
[28] Hussein Tarraf, *The Role of Corporate Governance in The Events Leading Up to The Global Financial Crisis: Analysis of Aggressive Risk-Taking*, 5 GLOBAL J. BUS. RES. 93,105 (2011).

improper incentive systems; (ii) the opportunity to take such risks; and (iii) the rationalization of risks taken.[29]

Let us, to test this proposition, revisit two of the world's biggest accounting frauds – *Enron* and *WorldCom*. The collapse of *Enron* came in December 2001, stunning Wall Street, and the world together, when it announced having incurred USD 618,000,000 (USD Six Hundred Eighteen Million) in net losses due to financial accounting malpractices. Market speculation did not bear this well, following which *Enron* slipped into an almost instantaneous bankruptcy.[30]

Enron's senior officials engaged a law firm to conduct a preliminary investigation regarding the allegations, which concluded with no findings on transactional irregularities.[31] Subsequently, *WorldCom*, encountered allegations of *male fide* accounting practices and misconduct, where USD 400,000,000 (USD Four Hundred Million) was claimed to have been withdrawn from its reserve account. It was further claimed that these funds had been diverted to inflate *WorldCom*'s income.[32]

If we were to move closer to home, it may become apparent that recent Indian banking governance failures are not exceptions to the above hypothesis. Let us consider the PNB case, which involved the advancement of high-value loans to 1 (one) luxury jeweller and his business associate via inauthentic bank guarantees. An internal report by PNB found that PNB employees had committed several procedural lapses which allowed the business persons to fund their businesses abroad.[33]

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[29] *Id.*, at 98.
[30] Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L. R. 357,401 (2003).
[31] *Id.*, at 361.
[32] *Id.*, at 369.
[33] Government of India (Requesting State) v. Nirav Deepak Modi (Requested Person), in the Westminster Magistrates' Court.

What is common to the above examples, (albeit occurring decades apart), is an (i) inaccurate account of the creditworthiness of the debtor; and (ii) viability of the debt. Often, board members appointed to such banks may seek to promote majority shareholder (and stakeholder) interests and may, therefore, nudge executives to rein in swift profits through loans that seem profitable at the outset.[34]

Accordingly, banks (through their key decision-makers) may forego a comprehensive risk analysis that measures the short-term versus long-term payoffs of the debt investment. Consequently, investments based on incomplete information may create bad credit cycles, thereby further increasing risk and overtime *negative returns*.[35]

III. THE CHALLENGE OF ROGUE AGENTS

The uncertainties and risks accompanying lending cycles discussed in Part II may be characterized as functions of an *agency problem*. An *agency problem* is said to arise when the welfare of the principal is contingent upon the actions or omissions of another party - the agent.[36] A *rogue agent*, may at times steer off the traditional path of agency, and (possibly, for self-interest) under *quid-pro-quo* arrangements, take decisions not necessarily in the principal's welfare. Here, the reference is to the bank and its company representatives, as agents to their shareholders (and stakeholders), as principals. This analogy, however, describes only the relationship; the real challenge arises in effectively incentivizing the agents to modify behaviour and pursue the interests of the principals. In cases where multiple agents exist (such as, in syndicated loans) this challenge may escalate.[37]

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[34] *Supra* note 25, at 94.

[35] John Armour et al., Agency Problems, Legal Strategies and Enforcement (John M. Ollins Centre for Law, Econ. and Bus., Discussion Paper No. 644, 2009), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Kraakman_644.pdf.

[36] *Id* at 2-3.

[37] Robert C. Hockett, *Are Bank Fiduciaries Special?* 68 ALA. L. REV. (2017), https://ssrn.com/abstract=2903627.

Legal scholars have often described the agency problem to be a consequence of *information asymmetry*, that is, a state where 1 (one) party – typically the agent (lender), is privy to vast volumes of relevant and sensitive information as opposed to the other party – the principal (bank shareholder/stakeholder).[38] A state of prolonged access to material information has the potential to create perverse incentives for agents to act in an opportunistic manner.[39] Such conduct may go against the very *raison d 'être* of the law of agency. In the present context, this information may typically relate to stock prices, knowledge of vested interests, or other factors affecting lending. Nonetheless, Armour, Hansmann, and Kraakman suggest several ways, in terms of *ex ante* and *ex post* strategies, that may be employed to address opportunistic conduct.

The suggestions include regulatory and governance strategies, the former which prescribe substantive terms of conduct, and the latter which allow for more direct control by the principal over the agents' behaviour. Regulatory strategies typically involve imposing constraints on agents' behaviour or allowing principals to exit the relationship of agency, on knowledge of surreptitious or unfavourable agent behaviour.

On the contrary, governance strategies allow for closer monitoring of self-serving behaviour through the elimination of perverse incentives altogether – done through a combination of *reward and trusteeship strategies*.[40]

IV. BANKING GOVERNANCE REGIME IN INDIA

Indian corporate governance has remained predominantly oriented towards a more *ex-ante* prescriptive framework, as opposed to an *ex-post*

[38] S*upra* note 34 at 8.
[39] S*upra* note 34 at 8.
[40] S*upra* note 34.

approach of standard creation.[41] The Indian corporate governance regime derives mostly from committee reports, such as the (i) Naresh Chandra Committee Report, 2009 (Report of the Confederation of Indian Industries Task Force on Corporate Governance)[42]; and (ii) the N. R. Narayana Murthy Committee Report on Clause 49 of the SEBI Listing Agreement.[43] In view of the above, the SEBI has subsequently issued a framework for disclosures and best corporate governance practices for listed companies.[44]

Specifically, in reference to banking corporate governance, the RBI on June 7, 2019, released the consolidated Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions 2019 ("**Prudential Norms**"),[45] in exercise of the powers conferred by the Banking Regulation Act, 1949 ("**BR Act**"),[46] and the Reserve Bank of India Act, 1934.[47] However, while the Prudential Norms provide a framework for early recognition, reporting, and time-bound resolution of stressed assets and NPAs – the internal policies of banks and financial institutions have been left to their discretion in restructuring cases.

Further, the National Guidelines on Responsible Business Conduct ("**NGRBC Guidelines**") published by the MCA in 2019 are entirely

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[41] CII, *Corporate Governance Recommendations for Voluntary Adoption Report of The CII Task Force on Corporate Governance* (Nov. 2019), http://www.mca.gov.in/Ministry/latestnews/Draft_Report_NareshChandra_CII.pdf.
[42] *Id.*
[43] Securities And Exchange Board of India, Corporate Governance in Listed Companies - Clause 49 of The Listing Agreement, SEBI/CFD/DIL/CG/1/2004/12/10 (Issued on Oct. 29, 2004; *See also*, Press Release, Securities and Exchange Board of India, Clause 49 of the Listing Agreement Revised (Oct. 29, 2004), https://www.sebi.gov.in/media/press-releases/oct-2004/clause-49-of-the-listing-agreement-revised_15777.html.
[44] *Id*; *See also*, Securities and Exchange Board of India, Format of Compliance Report on Corporate Governance by Listed Entities, SEBI/HO/CFD/CMD-2/P/CIR/2021/567 (Issued on May 31, 2021).
[45] Reserve Bank of India, Prudential Framework for Resolution of Stressed Assets, RBI/2018-19/203 (Issued on Jun. 7, 2019).
[46] Banking Regulation Act, No. 10 of 1949, §35AB (Ind.).
[47] Reserve Bank of India Act, No. 2 of 1934, §45JA (Ind.).

voluntary and therefore do not carry penalties for non-compliance.[48] Accordingly, the directory nature of the NGRBC Guidelines may further banks' reliance on internal governance guidelines, leaving reduced scope for coherence across diverse business sectors.

It may be noted that the Prudential Norms, however, allow for stricter enforcement as deemed appropriate by the RBI, against lenders engaging in (i) higher provisioning on stressed accounts; and (ii) status concealment and *evergreening* the stressed accounts.

Previously, the RBI in September 2002 published the Guidelines on Preventing Slippage of NPAs from the '*sub-standard*' category to the '*doubtful category*'.[49] The RBI provided the below common framework, with *de minimus* standards for compliance by banks and financial institutions.[50]

- Early recognition of the problem

An '*early alert*' system should be put in place for the purpose of governing internal monitoring by banks and financial institutions, prior to the conversion of '*special mention accounts*' ("**SMAs**") to an NPA account.[51] Accordingly, an account may be classified as an NPA based on the below indicative attributes:

a. delay in submission of stock statements, financial statements, and other control statements;
b. return of cheques issued by borrowers;

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48 MINISTRY OF CORP. AFFAIRS, GOV'T OF IND., NATIONAL GUIDELINES ON RESPONSIBLE BUSINESS CONDUCT (2019), https://www.mca.gov.in/Ministry/pdf/NationalGuildeline_15032019.pdf.
49 Reserve Bank of India, Guidelines on Preventing Slippage of NPA Accounts (Issued on Sept. 12, 2002).
50 *Id.*
51 *Id.*

c. devolvement of deferred payment guarantee instalments and non-payment within a reasonable period;
d. frequent devolvement of letter of credit and non-payment within a reasonable period;
e. frequent invocation of bank guarantees and non-repayment within a reasonable period;
f. return of bills and discounted cheques;
g. non-payment of discounted bill or bills under collection;
h. poor financial performance in terms of declining sales and profits, cash losses, net losses, erosion of net worth etc.;
i. incomplete documentation in terms of creation, registration of charges and mortgage etc.; and/or
j. non-compliance with the terms and conditions of sanction.[52]

The RBI has therefore suggested the creation of a new asset category, in view of the '*early alert*' system, being the SMA between '*standard*' and '*sub-standard*' for their internal tracking. Accordingly, an account may be classified as an SMA, based on the following indicative attributes:

a. the asset has potential weaknesses capable of resolution, though requiring close management attention;
b. the bank's weak loan origination/servicing policies with respect to the loan; and or
c. inadequate cash flows and management integrity.

- <u>Identifying borrowers with genuine interest</u>

Lenders must put internal and ergonomic systems in place to distinguish borrowers with repayment integrity, from those with high risk of non-repayment.[53]

[52] *Supra* note 48.
[53] It is important to note, subject to applicable laws, these guidelines may be viewed in line with the borrower demographic and corresponding standards of 'financial integrity' and repayment capacity.

- Timeliness and adequacy of response

Akin to the spirit of resolution processes under the IBC, *time is of the essence*. The earlier banks and financial institutions respond to deteriorating asset classes, the better their capacity to mitigate injury to the account, and underlying asset(s).

- Focus on cash flows

Banks may analyse traditional fund flows, along with conducting a liquidity or cash flow analysis to gauge whether loan repayments are making their way back as expected.

- Management effectiveness

The RBI has emphasized the vital role played by the management of banks and financial institutions to monitor and tackle SMAs and ward off potential NPAs. Accordingly, it has suggested conducting enterprise and debt viability studies, prior to extending further loans.

- Consortium/ multiple financing

In cases where the SMA relates to multiple lenders (agents) at a time, the RBI has recommended free flow of information and data, one might say, to reduce *information asymmetry* among consortium members. This may be particularly relevant in cases where the SMA is undergoing (i) debt restructuring under the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002; or (ii) debt resolution under the IBC. Thus, it may be argued that although lender priority viz repayment may conflict, the flow of information amongst consortium members must be as free as practicable.[54]

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[54] *Supra* note 48.

However, challenges to free information flow may heighten at the (board) management level. A common concern that arises among both private sector banks and PSBs is the deepening lack of board independence. Often, banks' lending decisions may be significantly influenced by the decisions of a few individuals. While independent directors may balance the scales of discretion[55], their sway may be limited in such matters given the general absence of (i) affirmative voting rights (entitlements); and (ii) adequate remuneration (incentives).[56]

From an external view, stakeholders would stand entitled to assume that internal disclosures have been rightfully carried out, as per the *doctrine of indoor management*.[57] However, in cases where such internal disclosures and information exchanges have not been carried out; on the breach, the principals may be left with little recourse but to wait for lengthy investigations to conclude.

In this sense, not only do disputes prolong debt recognition, and resolution or restructuring (as the case may be), but they may also simultaneously compound balance sheet stagnation due to costs through (i) litigation expenses, (ii) delayed debt servicing; and (iii) fluctuation in interest rates – all impacting the cyclical nature of NPAs. Within cross-border lending transactions, these costs may inflate due to (i) fluctuations in foreign exchange rates; or (ii) expenses related to more intricate forms of dispute resolution, such as arbitration.[58]

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[55] The Companies Act, No. 18 of 2013, §149(6) (Ind.).

[56] SEBI, *Consultative Paper on Reviews of Corporate Governance Norms in India,* https://www.sebi.gov.in/sebi_data/attachdocs/1357290354602.pdf.

[57] Royal British Bank v. Turquand, (1856) 6 E&B 327. The *doctrine of indoor management* allows external stakeholders to assume that all company transactions have been duly authorized and are compliant (in letter and spirit) with the company's constitutional documents.

[58] Alice Sebastian et al., Impact of Real Exchange Rate Volatility on Use-Based Industrial Production in India (RBI, Working Paper No. 5, 2014), https://rbi.org.in/scripts/PublicationsView.aspx?id=15758; *See also*, Sreejata Banerjee & Divya Murali, Stress Test of Banks in India: A VAR Approach (Madras School of Econ.,

In view of the above, this article proposes that we combine the reward and trusteeship systems of corporate governance, with a specific focus on the latter, to expand on the existing framework. The trusteeship system works to identify and subsequently neutralize potential conflicts of interest *ex ante*, which is before the agents' actions. While the existing framework provides for the disclosure of related party transactions[59] to the company's board, complementary guidelines for conflict identification may assist banks to identify borrowers with genuine interest and navigate consortium lending effectively.[60] In the absence of like incentives, agents may not operate to receive personal gain, and might, therefore, be more likely to pursue those of their principal.[61]

Considering conflict elimination, academics have oft-suggested increased reliance on external auditors and independent directors, to encourage greater neutrality in lending relationships.

V. CRAS AND REGULATORY REQUIREMENTS

The above discussion has attempted to bring to the fore some of the subsisting key risks that are posed by the current banking governance regime. Accordingly, there is a need to revisit this framework due to its pervasive role in the bank performance as catalysts within market economies.[62] The 'agency problem' may also arise viz. external agents and consultants (sub-agents), such as with CRAs.

Working Paper No. 102, 2015), https://www.mse.ac.in/wp-content/uploads/2016/09/Working-Paper-102.pdf.

[59] The Companies Act, No. 18 of 2013, §118 (Ind.) & Companies (Meeting of Board and its powers) Rules, 2014, Gazette of India, pt. II sec. 3(i), Rule 15 (Mar. 31, 2014).

[60] *Supra* note 40.

[61] *S*upra note 35 at 9.

[62] NICOLA CETORELLI, BANKING AND REAL ECONOMIC ACTIVITY IN MACROECONOMIC PERSPECTIVES IN BANKING, Oxford Handbook for Banking (Oxford University Press, 2nd ed. 2010); *See also*, Marco Da Rin & Thomas Hellmann, Banks as Catalysts for Industrialization (Stan. U., Working Paper No. 443, 2001),

The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 ("**SEBI CRA Regulations**") mandate that CRAs must carry out periodic reviews and assessments of securities ratings. [63]Further, under the CRAs are prohibited from withdrawing credit ratings for securities, having outstanding obligations.[64] However, any companies owning such rated securities, and undergoing an amalgamation or a merger, shall not be subject to such rating retentions.[65] The SEBI has also provided a code of conduct for CRAs, including among others, provisions on (i) good governance practices; (ii) disclosure of rating methodologies; and (iii) maintaining arm's length relationships between its credit rating services and other activities.[66]

In this regard, outsourcing certain functions to external entities such as CRAs, along with actuarial and audit experts may reduce the probability of conflict of interest between agents (banks) and principals (bank shareholders/stakeholders). However, this may not eliminate risks to the performance and integrity of these functions altogether. In the recent past, the reliability and veracity of credit ratings have come to the forefront. As a result, misstatements made by CRAs arising out of opaque decision making, and non-regulation of compliances may still lead to poor decision making by lending participants.[67]

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https://deepblue.lib.umich.edu/bitstream/handle/2027.42/39827/wp443.pdf%3Bjsessionid%3D4918DC4AEF7E78434BA7C48943E1777F?sequence%3D3.

[63] SEBI, Review of regulatory framework for Credit Rating Agencies (CRAs) (2018), https://www.sebi.gov.in/sebi_data/meetingfiles/jan-2018/1515574457283_1.pdf.

[64] Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, Gazette of India, pt. III sec. 4, Reg. 16(3) (July 7, 1999).

[65] *Id.*

[66] Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, Gazette of India, pt. III sec. 4, Sch. III (July 7, 1999).

[67] Nan S. Ellis & Steven B. Dow, *Attaching Criminal Liability to Credit Rating Agencies: Use of The Corporate Ethos Theory of Criminal Liability*, 17(1), U. PA. J. BUS. L. 202 (2015); *See also*, ANDREAS KRUCK, PRIVATE RATINGS, PUBLIC REGULATIONS: CREDIT RATING AGENCIES AND GLOBAL FINANCIAL GOVERNANCE 137 (Palgrave Macmillan, 2011).

VI. RISK AND REWARD? QUALIFYING CRITERIA FOR DIRECTORS' COMPENSATION

The present discourse on board remuneration focuses primarily on bringing rewards for PSBs at par with private sector banks by curbing disproportionate pay-outs in the latter.[68] However, this may not in itself be sufficient to enhance corporate governance standards. A resultant inadequacy arises because *post-facto* rewards may not negate opportunistic incentives. Agents within a bank may be equally if not more inclined to pursue "*high powered*" incentives such as monetary gain despite rewards, over "*low-powered*" incentives such as personal conscience and reputation.[69]

The trusteeship system proposes creating a deliberate imbalance between "*high powered*" incentives and "*low powered*" incentives[70] As Kraakman suggest, this imbalance can be created through the 'independent director', who when functioning on their own accord, may not profit from the decisions that may otherwise, disproportionately benefit the bank (i.e., its dominant agents).[71]

In the Indian context, such a shift of corporate governance has been instituted in various ways. On November 4, 2019, the RBI issued the Guidelines on Compensation of Whole Time Directors/ Chief Executive Officers/ Material Risk Takers and Control Function Staff ("**Compensation Guidelines**") for remuneration payable to top management at private sector banks and foreign banks operating in India.[72] Guideline 6 of the Compensation Guidelines anchors remuneration to risk-

[68] Ekta Selarka, Corporate Governance Practices in India (Madras Sch. Of Econ., Working Paper No. 173, 2018), http://www.mse.ac.in/wp-content/uploads/2018/08/Working-Paper-173.pdf.
[69] *Supra* note 35 at 9.
[70] *Supra* note 35 at 6.
[71] *Supra* note 35 at 9.
[72] Reserve Bank of India, Guidelines on Compensation of Whole Time Directors/ Chief Executive Officers/ Material Risk Takers and Control Function Staff, RBI/2019-20/89 (Issued on Nov. 4, 2019).

taking by top management being '*material risk takers*', satisfying the following:

- <u>Standard qualitative criteria</u>: The role and decision-making power of staff members (e.g., senior manager, member of management body) having jointly or individually, the authority to commit significantly to risk exposures.
- <u>Standard quantitative criteria</u>:

a. the total remuneration exceeds a certain threshold; the determination of which may be done prudently by the bank;
b. the staff members are included among the 0.3% (zero-point three percent) of staff with the highest remuneration in the bank; or
c. the remuneration is equal to or greater than the lowest total remuneration of senior management and other risk-takers.

Arguably, while the sole qualitative criteria allow for the assessment of actual risk exposures, the reasoning provided within the quantitative criteria assumes that existing remuneration is already proportionate to risk appetite/exposure. Often, it may very well be the case that certain top management are risk-averse or risk-immune and yet, receive remuneration unaligned with their risk exposure. Therefore, the above quantitative criteria may be reviewed to account for indicative risk values and thresholds, to arrive at proportionate compensation for material risk-takers, and not vice-versa.

VII. NPAS IN EFFECT – CROSS-STATUTE CONSEQUENCES

In the aftermath of several financial frauds, regulators the world over, have been inclined towards re-instating investor confidence and creating more robust financial reporting systems. In this view, the United States passed the **SOX** which seeks to (i) improve accounting practices and

oversight; (ii) allow greater autonomy to auditors; and (iii) reinstate transparency in commercial transactions.[73]

Although penalties and imprisonment are the appropriate sanctions in the west, particularly in the United States, their implementation has often been critiqued. For example, the SOX doubled the maximum prison term for securities fraud and quadrupled the maximum term for mail and wire fraud, thereby creating an entirely new offense with higher penalties. Financial fraud in the United States, currently has an outer limit of 30 (thirty) years in terms of prison time.[74] Although the deterrence value of punitive sanctions is debatable, it may be argued that akin to any other crime, individual elements such as preparation, opportunity, and *incentive (here, motive)* must be thoroughly examined before placing blanket punishments on inherent criminality itself.

Likewise, under Indian law, the impact of corporate governance may permeate into cross-statute enforcement, given that the appointment of and remuneration payable to *material risk takers* may be subject to general corporate compliance, under the (Indian) Companies Act, 2013. Interestingly, India is one of the few jurisdictions which allows for pre-screening requirements for listed public companies in reference to (i) nomination to the board of directors[75]; and (ii) internal policies governing remuneration (for fixed and incentive pay) to senior management.[76]

Notably, in reference to white-collar crime regulation, the Indian Parliament has upped the ante through the Prevention of Corruption

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[73] Stephen Wagner & Lee Ditmar, *The Unexpected Benefits of Sarbanes-Oxley* (April 2006), https://hbr.org/2006/04/the-unexpected-benefits-of-sarbanes-oxley.
[74] Attorney General, Field Guidance on New Criminal Authorities, enacted in the Sarbanes-Oxley Act of 2002 (H.R. 3763) Concerning Corporate Fraud and Accountability (Mar. 7, 2017), https://www.justice.gov/archives/ag/attachment-attorney-general-august-1-2002-memorandum-sarbanes-oxley-act-2002.
[75] The Companies Act, No. 18 of 2013, §178(2) (Ind.).
[76] The Companies Act, No. 18 of 2013, §178(4) (Ind.).

(Amendment) Act, 2018. Under the amended the PoCA, upon breach, persons responsible for commercial organizations may be liable to be punished with imprisonment for a term ranging from 3 (three) to 7 (seven) years, with fine.[77]

Further, money launderers under the Prevention of Money Laundering Act, 2002 are liable to penalties akin to the PoCA.[78] Accordingly, Indian law also provides for a blend of punitive and monetary consequences. Nonetheless, arguably, mere punitive measures may not guarantee deterrence.

VIII. CONCLUSION

The nature of business is ruled by uncertainty. Accordingly, volatility in market conditions is bound to affect a borrower's repayment capacity. It may, therefore, be unreasonable to always expect a '*perfect borrower*'. Accordingly, it may make more sense to reconsider the stages preceding debt, along with mitigating surrounding circumstances to better the odds of '*good loans*.'[79] Accordingly, the question that arises is whether the regulatory modifications should be in terms of enhanced penalties or the nature of sanctions themselves? Considering past inadequacies of a system based purely on *ex-post* economic sanctions, we may consider a complementary framework, through a *prima facie* review and correction of conflict of lenders' interests, so that the *ex-post* imposition of penalties may be reduced by early recognition of perverse incentives.

IX. SUGGESTIONS & RECOMMENDATIONS

It may be argued that the surge of NPAs can be contained through a more refined corporate governance regime, the cornerstones of which should be high transparency in organizational processes, sector-based and

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[77] The Prevention of Corruption Act, No. 49 of 1988, §9 (Ind.) and The Prevention of Corruption Act, No. 49 of 1988, §10 (Ind.).

[78] Prevention of Money Laundering Act, No. 15 of 2003, §4 (Ind.).

[79] Mahesh Kumar Jain*,* Building A More Resilient Financial System in India Through Governance Improvements, India International Centre, New Delhi (June 18, 2021), https://rbi.org.in/scripts/BS_ViewBulletin.aspx?Id=20497.

standardized internal monitoring systems, and correspondingly, balanced (qualitative and quantitative) incentives for banking management:

a. *Firstly*, the urgent need for transparency in banking transactions can be met through an open channel of communication between agent and principal. Although this seems utopian, it may be effected through a comprehensive system of incentive identification and disclosure. Therefore, the elementary step could be stricter disclosure requirements for all banks; in effect an *ex-ante* trusteeship strategy to neutralize conflict of interest and promote the long-term welfare of both agent and principal.[80] In particular, the kind of policies that would allow for authentic and complete disclosure can only be decided as per generally accepted sectoral practices.
b. *Secondly*, while banks are allowed wiggle room to decide their governance systems, a *viable* combination given the proposed *ex ante* approach to conflicts of interest would include enhancing *ex post* reward mechanisms. While both trusteeship and reward approaches belong to the incentive strategies,[81] prescriptive standards for adequate remuneration and benefits may deter the formation of "*high-powered incentives*"[82] that could substantively breach the agency. It could be said that among others, one reason bank officials and managers seek monetary gain, albeit at their principal's risk outside the agency, is that they may not receive it in sufficient degrees within it.[83]
c. *Thirdly*, we might address the space where transparency and rewards conflate to dictate how borrowers themselves fit in within governance strategies. This element has less to do with *how* agents (banks) behave vis-à-vis their principals

[80] *Supra* note 35, at 9.
[81] *Supra* note 35, at 5.
[82] *Supra* note 35, at 9.
[83] Rezart Dibra, *The Role of Corporate Governance Failure in the Banking Sector,* 12 EUR. SCI. J. 68, 72 (2016).

> (shareholders/stakeholders), and more with how they transact with external agents, among others, CRAs.[84] The desire to adopt and operate based on accurate and unbiased credit ratings, is intertwined with the duty of agents to pursue principal interests. In other words, if the above requirements of disclosure and incentive are appropriately addressed, the integrity of the principal-agent relationship in terms of external transactions may naturally fall into place.

It is pertinent to note that under the Union Budget, the Finance Ministry concomitantly called for cleaning up banks' books, given the high level of provisioning for stressed (non-performing) loans as non-yielding contingent assets. The Finance Ministry proposed the establishment of (i) an asset reconstruction company ("**ARC**"); and (ii) an asset management company ("**AMC**"), to consolidate such assets and realize value.[85]

In pursuit of the budget proposals for stressed assets, the Finance Ministry recently announced government guarantees which would back the acquisition of bad assets by a *bad bank* – the National Asset Reconstruction Company Limited ("**NARCL**").[86] It may be said that the move is intended to lighten the burden of bad (non-performing) loans from the books of afflicted banks. Further, it has been proposed that the Indian Debt Resolution Company Limited would manage the asset reconstruction process and engage with relevant professionals and experts to facilitate this transition.[87]

The role of PSBs and financial institutions remains significant in the resolution process, given that they would maintain a 49% (forty nine

[84] Avinash D. Persaud, *The Right and Wrong Way to Regulate Credit Rating Agencies*, ECON. & POL. WEEKLY, (Jul. 10, 2019), https://www.jstor.org/stable/40276568.
[85] *Supra* note 1, at 15-16.
[86] Press Release, Ministry of Finance, Frequently Asked Questions Regarding Central Government Guarantee to Back Security Receipts Issued by National Asset Reconstruction Company Limited for Acquiring of Stressed Loan Assets (September 16, 2021), https://pib.gov.in/PressReleseDetailm.aspx?PRID=1755466.
[87] *Id.*

percent) stake in the NARCL. In view of increasing responsibilities for and entrustment to PSBs in tackling the NPA challenge, further regulatory guidance on PSB remuneration mechanisms and internal processes may be expected.[88]

[88] *Id.*

CODE OF CONDUCT FOR COC: DEATH KNELL FOR CIRP

Priyanshu Shrivastava[*]

ABSTRACT

The Insolvency and Bankruptcy Code, 2016 follows a 'creditor-in-control' model for resolution of debts. Consequently, the CoC is at the centre of the CIRP; it takes all key decisions, from providing interim finance to approving/not approving the resolution plans. The concept of 'commercial wisdom' dictates that the decision-making authority of the CoC cannot be questioned unless it goes against IBC or its objectives. The IBBI Discussion Paper proposes a Code of Conduct which, if implemented, will overregulate the CoC and eventually derail the CIRP with infructuous practical implications. The author makes an attempt to, first, dissect the existing legal principles and the scope of judicial scrutiny vis-à-vis CoC's decision making authority; second, analyse and critique the IBBI Discussion Paper in light of the regulatory framework already in place; and third, propose a balanced approach so as to make CIRP more efficient and effective without significantly impacting the autonomy and the commercial wisdom of the CoC to take independent business decisions.

Keywords: Corporate Insolvency, Resolution, Insolvency and Bankruptcy Code, Committee of Creditors.

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I. INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 ("**IBC**") was developed with a crucial objective of speedy resolution of bankrupt companies.[1] As a break from the past, IBC has become the preferred route for resolution and has achieved commendable success.[2] The Committee of Creditors ("**CoC**") is at the centre of the Corporate Insolvency Resolution Process ("**CIRP**") and plays a crucial role in the same.[3] CoC's business decisions, which are a part of its 'commercial wisdom,' cannot be questioned unless it goes against IBC and/or its objectives.[4] On August 27, 2021, the Insolvency and Bankruptcy Board of India ("**IBBI**") released a Discussion Paper proposing, *inter alia*, modification of the CoC's functioning.[5] The annexed Code of Conduct in the Discussion Paper intends to regulate the decision making process of the CoC.[6] As it will be shown, this Code of Conduct is a disproportionate response and has the potential of overregulating the CoC and eventually derailing the CIRP.

In this light, it becomes important to analyse the current position of law in light of the proposed Code of Conduct. In the second section of this article, IBC's 'creditor-in-control' model is briefly explained [**II**.]. Then, in the third section, the scope of judicial scrutiny is discussed vis-à-vis CoC's decision making authority [**III**.]. In the fourth section of this article, IBBI's

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[1] The Insolvency and Bankruptcy Code, No. 31 of 2016, Acts of Parliament, 2016 (Ind.) [hereinafter INSOLVENCY & BANKRUPTCY CODE, 2016].

[2] *Decoding the Code: Survey on Twenty-One Months of IBC in India*, PRICEWATERHOUSECOOPERS: PUBLICATIONS (2018), https://www.pwc.in/assets/pdfs/publications/2018/decoding-the-code-survey-on-twenty-one-months-of-ibc-in-india.pdf.

[3] *Id.*.

[4] *Id.* at 2.

[5] INSOLVENCY AND BANKRUPTCY BOARD OF INDIA, DISCUSSION PAPER (Aug.27, 2021), https://ibbi.gov.in/Discussionpaper-CIRP-27Aug2021.pdf [hereinafter IBBI DISCUSSION PAPER].

[6] *Id.*

Discussion Paper is discussed and critiqued with specific emphasis on its rationale and implications [**IV**.]. In the final section of this article, a two-pronged approach is proposed to find the right balance so as to make CIRP more efficient and effective without significantly impacting the autonomy and the commercial wisdom of the CoC to take independent business decisions [**V**.].

II. STATUTORY SCHEME — 'CREDITOR-IN-CONTROL' MODEL

IBC follows a "creditor-in-possession" model.[7] That is, after a corporate debtor ("**CD**") commits a default, the control of the company shifts to the financial creditors.[8] These financial creditors comprise the CoC in accordance with Section 21 of IBC.[9] The Bankruptcy Law Reforms Committee ("**BLRC**"), in its comprehensive report, has stated that "[a]ll decisions on matters of business will be taken by a committee of the financial creditors."[10] The following paragraphs briefly delineate how the CoC is at the centre of the CIRP:

- **Appointment of the Resolution Professional:** Section 22 of IBC bestows upon the CoC the power to either appoint the Interim Resolution Professional ("**IRP**") as the Resolution Professional ("**RP**") or to replace the IRP with another RP.[11] This appointment is done through a "majority vote of not less sixty-six per cent of the voting share of the financial creditors." Furthermore, under Section 27 of IBC, the CoC can also remove and replace the RP by a vote

[7] *Primer on Insolvency and Bankruptcy Code 2016: Analysis of the Seminal Supreme Court Rulings that Shaped the Code*, SARVADA: INSIGHT (2020), https://sarvada.co.in/wp-content/uploads/2021/08/1_Sarvada-Legal-IBC-Primer.pdf.
[8] *Id.*
[9] INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 21.
[10] BANKRUPTCY LAW REFORMS COMMITTEE, THE REPORT OF THE BANKRUPTCY LAW REFORMS COMMITTEE (Nov. 2015), https://ibbi.gov.in/BLRCReportVol1_04112015.pdf [hereinafter REPORT OF THE BANKRUPTCY LAW REFORMS COMMITTEE].
[11] INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 22(1).

of sixty-six per cent of voting shares.[12] It is important to note that the provision does not require a rationale for such removal and replacement; the vote in itself is sufficient.[13]

- **Certain Actions of the Resolution Professional:** Section 28(1) of IBC states that, during CIRP, the RP cannot carry out certain actions without the approval of the CoC;[14] these actions require a vote of sixty six percent of the voting shares.[15] Omission to take a prior approval of the CoC results in the voidness of any such action(s);[16] in such a situation, the CoC also has an option to report the RP to IBBI.[17] Section 28(1) of IBC contains a set of thirteen specific actions (e.g., creation of security over assets of the CD,[18] undertake related party transaction,[19] and make changes in the management of the CD)[20] that require prior approval of the CoC.[21] Similarly, Regulation 29 of Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 ("**CIRP Regulations**") states that the RP will necessarily have to take the approval of the CoC, through a vote of sixty-six per cent of voting share, to carry out any "[s]ale of assets outside the ordinary course of business."[22] It follows that even though it is the responsibility of the RP to manage the operations of the CD,[23] the true control of the CD is in the hands of the CoC.

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[12] INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 27.
[13] State Bank of India v. Ram Dev International Ltd., (2018) SCC OnLine NCLAT 948; Power Finance Corp v. Mahendra Khandelwal, NCLT Hyderabad Bench (IA No. 300 of 2020).
[14] INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 28(1).
[15] *Id.* § 28(3).
[16] *Id.* § 28(4).
[17] *Id.* § 28(5).
[18] *Id.* § 28(1)(b).
[19] *Id.* § 28(1)(f).
[20] *Id.* § 28(1)(j).
[21] *Id.* § 28(1).
[22] Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, Gazette of India, pt. III sec. 4, Reg. 29, (Nov. 30, 2016).
[23] INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 23(1).

- **Extension of CIRP Timeline:** Section 12(1) of IBC provides that the CIRP should get completed within a period of one hundred and eighty days from the date of the initiation application.[24] Furthermore, as stated in Section 12(2) of IBC, the RP can make a request to the Adjudicating Authority ("**AA**") to extend the CIRP timeline.[25] However, to do this, the RP requires the approval of the CoC through a vote of sixty six percent of the voting shares.[26] Although the 'mandatory' nature of the timeline has been struck down by the Supreme Court of India ("**SC**") in ***Essar Steel v. Satish Kumar Gupta,***[27] the approval of the CoC remains crucial. This is because the CD will be placed under liquidation by the AA if an extension is not taken.[28] Thus, how the CoC acts in these circumstances impacts all the stakeholders, right from the CD to an unpaid employee.
- **Cessation of CIRP:** Section 12A of IBC authorises the CoC to cease the ongoing CIRP by approving the withdrawal application made by the applicant through a ninety per cent voting share.[29] In other words, the main decision to withdraw rests upon the CoC and not the applicant who had filed for initiation of CIRP under Sections 7, 9, or 10 of IBC.
- **Approval of the Resolution Plan:** Section 30(4) of IBC provides for the power of the CoC to approve a resolution plan, after assessing its viability and feasibility, through at least sixty-six percent of the voting share.[30] If the CoC does not approve and send any resolution plan to the AA within the maximum period permitted for

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[24] *Id.* § 12(1).
[25] *Id.*
[26] INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 12(2).
[27] Committee of Creditors of Essar Steel v. Satish Kumar Gupta, (2019) SCC OnLine SC 1478.
[28] INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 33.
[29] *Id.* § 12A.
[30] *Id.* § 30(4); *See also*, *Id.* § 5(28)

CIRP (330 days),[31] the AA will pass an order for the liquidation of the CD.[32]

Thus, as the above-mentioned paragraphs indicate, the CoC is at the centre of the CIRP and plays a crucial role in the same. CoC's role was best explained by the SC in ***Essar Steel v. Satish Kumar Gupta*** when it stated that "[w]hat is important is that it is the commercial wisdom of this majority of creditors which is to determine, through negotiation with the prospective resolution applicant, as to how and in what manner the corporate resolution process is to take place."[33]

III. SCOPE OF JUDICIAL SCRUTINY & THE CONCEPT OF 'COMMERCIAL WISDOM'

As stated in the previous section, CoC plays a pivotal role in managing the CIRP;[34] it is natural for other stakeholders, like resolution applicant or CD, to have grievances with the decisions taken by the CoC. These grievances result in multiple suits against the decision making of the CoC. The main issue that has arisen is: whether and to what extent can the CoC's decisions be challenged?[35] The SC, in ***K. Sashidhar v. Indian Overseas Bank***,[36] addressed this issue by stating that the discretion of the AA, with respect to the judicial scrutiny under Section 31 of IBC,[37] is limited to checking the legal requirements of a resolution plan under Section 30(2)[38] and Provisos to Section 30(4) of IBC.[39] The following observation of the SC aptly explains the scope of judicial scrutiny:[40]

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[31] *Id.* § 12; *See* Committee of Creditors of Essar Steel v. Satish Kumar Gupta, (2019) SCC OnLine SC 1478 (it was held in this case that the time elapsed due to legal proceedings is excluded).

[32] INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 33(1).

[33] Essar Steel (India) Ltd. Committee of Creditors v. Satish Kumar Gupta, ¶ 64 (2020) 8 SCC 531.

[34] *See supra* note 2.

[35] K. Sashidhar v. Indian Overseas Bank and Ors, (2019) 12 SCC 150

[36] *Id.*

[37] INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 31.

[38] *Id.* § 30(2).

[39] *Id.* § 30(4).

[40] K. Sashidhar v. Indian Overseas Bank and Ors, (2019) 12 SCC 150 (Ind.)

> *[t]he provisions investing jurisdiction and authority in NCLT or NCLAT as noticed earlier, have not made the commercial decision exercised by CoC of not approving the resolution plan or rejecting the same, justiciable. This position is reinforced from the limited grounds specified for instituting an appeal that too against an order 'approving a resolution plan' under Section 31. First, that the approved resolution plan is in contravention of the provisions of any law for the time being in force. Second, there has been material irregularity in exercise of powers 'by the resolution professional' during the corporate insolvency resolution period. Third, the debts owed to operational creditors have not been provided for in the resolution plan in the prescribed manner. Fourth, the insolvency resolution plan costs have not been provided for repayment in priority to all other debts. Fifth, the resolution plan does not comply with any other criteria specified by the Board.*

This position was reaffirmed by the SC in the case of ***Essar Steel v. Satish Kumar Gupta***.[41] In this case, the SC rejected the argument that the CoC acts in any fiduciary capacity to the stakeholders;[42] rather, it stated that the CoC takes a "business decision based upon ground realities by a majority, which then binds all stakeholders, including dissentient creditors."[43] However, as a balancing act, the SC stated that the CoC must take into consideration the following factors while arriving at a decision: *first*, the CD should continue as a going concern during CIRP; *second*, value of the CD's assets should be maximised; and *third*, the interests of all the stakeholders, and not merely the financial creditors, should be balanced.[44]

Therefore, the business decision of the CoC cannot be challenged unless it goes against the legal requirements stated in IBC and the above-mentioned decisions. Through the concept of 'commercial wisdom,' the Indian Judiciary has developed a crucial nuance between the rationale

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[41] Essar Steel (India) Ltd. Committee of Creditors v. Satish Kumar Gupta, (2020) 8 SCC 531 (Ind.)
[42] *Id.*
[43] *Id.* at 146.
[44] *Id.*

behind the CoC's business decision and its legal requirements, and has taken a fairly balanced approach towards regulating the same.

IV. PROPOSED CODE OF CONDUCT FOR THE COC

In this section, the IBBI Discussion Paper dated August 27, 2021 ("**Discussion Paper**") is discussed in context of the proposed Code of Conduct for the CoC.[45] According to IBBI, a Code of Conduct is required because the CoC "functions in an unregulated environment" and "questions have been raised in various fora about the action of CoC being detrimental to objectives of the Code."[46] A similar view was expressed by the Parliamentary Standing Committee on Finance.[47] In this light, it becomes crucial to discuss the following aspects of the Discussion Paper and the proposed Code of Conduct.

A. COC — CURRENTLY UNREGULATED?

The Discussion Paper, at the outset, acknowledges the creditor-in-control CIRP model and how the CoC plays a central role in deciding the fate of the CD.[48] However, it goes on to state that the CoC must act in the "best interest of all stakeholders" as it is the "custodian of public trust during resolution process."[49] This seems to be a non-sequitur: how can financial creditors, who are primarily driven by a profit motive, be expected to make a business decision based on 'public trust?' The fundamental rationale behind the Code of Conduct is flimsy at best. This inference is further strengthened from the IBC framers' intentions when they state in the BLRC Report that,[50]

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45 IBBI DISCUSSION PAPER, *supra* note 5.
46 *Id.*
47 Brajesh Kumar, *Is the power of Committee of Creditors Unquestionable? No; it's not, suggests Parliamentary Standing Committee on Finance*, ZEE BUSINESS (Aug.10, 2021), https://www.zeebiz.com/india/news-is-the-power-of-committee-of-creditors-unquestionable-not-suggests-parliamentary-standing-committee-on-finance-162466.").
48 IBBI DISCUSSION PAPER, *supra* note 5.
49 *Id.*
50 REPORT OF THE BANKRUPTCY LAW REFORMS COMMITTEE, *supra* note 10.

> *[in the IBC Framework,] what is visualised for individuals is to enable a negotiated settlement between creditors and debtor without active involvement of the court. The principle is to allow greater flexibility in the repayment plans, and a time to execute the plans, that can be acceptable to both parties. If creditors and debtors can settle on such a plan out of court, what matters for the system is that there is a record of this settlement and that it can affect the premium of future credit transactions.*

In this regard, the SC has already struck a fine balance by only regulating the substantive and procedural requirements of law, and not impacting the autonomy of the CoC to take an independent business decision.[51] These calls into question the very veracity of the fundamental assertion made in the Discussion Paper by IBBI that the CoC "functions in an unregulated environment." In fact, IBBI had released a document titled *Charter of Responsibilities for the IRP/RP and CoC in a CIRP* ("**Charter**") in 2019.[52] In this Charter, IBBI merely explained the evolving jurisprudence of the IBC in context of the RP's and the CoC's respective responsibilities. The Charter had even cited ***K. Sashidhar v. Indian Overseas Bank***[53] to explain the role of the CoC in a CIRP.[54] IBBI had expressed no reservations about this position; this makes the *volte-face* assertions made in the Discussion Paper even more difficult to understand and accept.

Furthermore, financial creditors, who comprise the CoC, are primarily entities that are already well regulated by the Reserve Bank of India or the Securities and Exchange Board of India.[55] The proposed Code of Conduct,

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51 *See supra* note 3.

52 INSOLVENCY AND BANKRUPTCY BOARD OF INDIA, CHARTER OF RESPONSIBILITIES OF IRP / RP AND COC IN A CIRP (2019), https://ibbi.gov.in/uploads/legalframwork/58b3837f3e594c5ed43f5ffa54c7c270.pdf [hereinafter CHARTER OF RESPONSIBILITIES].

53 K. Sashidhar v. Indian Overseas Bank and Ors, (2019) 12 SCC 150.

54 CHARTER OF RESPONSIBILITIES, *supra* note 52.

55 Rajat Sethi, *An alternative approach to a Code of Conduct for the Committee of Creditors in an IBC Process*, NLS BUS. L. REV.: BLOG (Sept.21, 2021) https://www.nlsblr.com/post/an-alternative-approach-to-a-code-of-conduct-for-the-committee-of-creditors-in-an-ibc-process.

which contains thirty-one duties of the CoC,[56] intends to regulate almost every aspect of how the CoC operates. Some of the duties are: maintaining "objectivity" while exercising decisions, not influencing the committee to get any "undue gain," and participating "actively, constructively and effectively." It follows that, on top of the existing legal framework, if this Code of Conduct comes into effect as 'law,' it will result in overregulation of the CoC.

B. IBBI'S RATIONALE — INSUFFICIENT

As part of its rationale, the Discussion Paper has mentioned specific cases and instances that are, in IBBI's opinion, concerning.[57] As it will be seen, the rationale provided in the Discussion Paper is insufficient as most of these cases and instances are already governed by, and rectified through, the existing legal framework. For instance, in *Andhra Bank v. Sterling Biotech,*[58] the CoC had, through a 90.32% vote share, approved a resolution plan made by applicants who were ineligible under Section 29A of IBC.[59] The Discussion Paper cited this case to place doubt on the 'commercial wisdom' of the CoC. In such cases, under Section 31 of IBC, the AA already has an unequivocal authority to reject the submitted resolution plan.[60] Similarly, the Discussion Paper cited[61] ***Bank of Baroda v. Sisir Kumar Appikatla***, where the AA rejected a resolution plan due to reason of ineligibility.[62] The Discussion Paper also cited ***Bhushan Power & Steel Ltd*** CIRP, where the RP and CoC had an arrangement for the payment of an exorbitant amount to the lender's counsel;[63] even this was legally prohibited by law through an IBBI Circular.[64]

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[56] IBBI DISCUSSION PAPER, *supra* note 5.
[57] IBBI DISCUSSION PAPER, *supra* note 5.
[58] Andhra Bank v. Sterling Biotech Limited, (2019) SCC OnLine NCLT 5835.
[59] *Id.*; INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 29A.
[60] *Id.* §§ 30(4), 31.
[61] IBBI DISCUSSION PAPER, *supra* note 5.
[62] Bank of Baroda v. Sisir Kumar Appikatla, (2020) SCC OnLine NCLAT 1019.
[63] IBBI DISCUSSION PAPER, *supra* note 5.
[64] *Id.*

Lastly, it is crucial to take note of the ***Videocon Group*** CIRP;[65] although the IBBI Discussion Paper has not cited this case, it has raised several eyebrows with respect to CoC's 'Commercial Wisdom.'[66] In this CIRP, a resolution plan was approved by the CoC with 95.85% haircut, enabling the creditors to recover only 4.15% of the outstanding debt.[67] *Prima facie*, this case sounds like a gross misuse of the power and authority that the CoC has been endowed with. However, through reading between the lines, it is found out that multiple variables were in play.[68] The CIRP had been going on for several years with multiple unsuccessful resolution plans; the value of the stressed assets was continuously depreciating.[69] On top of this, the COVID-19 pandemic substantially diminished the asset value.[70] Keeping these variables in mind, the huge haircut does not come as a surprise. It follows that the *Videocon Group* CIRP does not represent the general norm, but a rare exception.

These examples are indicative rather than exhaustive. However, their analysis sufficiently proves that IBBI's rationale behind proposing a Code of Conduct is insufficient. The above-mentioned instances, *albeit* concerning, do not warrant the imposition of a whole Code of Conduct,

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[65] Bank of Maharashtra v. Videocon Industries Ltd., (2021) SCC OnLine NCLAT 324
[66] *Videocon insolvency: Creditors to take 96% haircut on dues; NCLT requests increase in pay-out*, ECON. TIMES (Jun. 16, 2021), https://economictimes.indiatimes.com/news/company/corporate-trends/videocon-insolvency-creditors-to-take-96-haircut-on-dues-nclt-requests-increase-in-pay-out/articleshow/83561586.cms; Vedaant S Agarwal et. al., *Videocon Saga: Does Commercial Wisdom Justify Huge Haircuts?*, INDIAN REV. CORP. & COM. L. (Aug. 7, 2021, https://www.irccl.in/post/videocon-saga-does-commercial-wisdom-justify-huge-haircuts; Gopika Gopakumar, *NCLT questions haircut taken by Videocon Industries creditors*, LIVEMINT (Jun.15, 2021), https://www.livemint.com/companies/news/nclt-questions-vedanta-s-bid-value-for-videocon-firm-to-delist-as-part-of-resolution-11623765692793.html.
[67] Bank of Maharashtra v. Videocon Industries Ltd., (2021) SCC OnLine NCLAT 324.
[68] Rajat Sethi, *The Videocon Insolvency Resolution Process: Is reading between the lines warranted?*, NLS BUS. L. REV.: BLOG (Aug. 5, 2021), https://www.nlsblr.com/post/the-videocon-insolvency-resolution-process-is-reading-between-the-lines-warranted.
[69] Bank of Maharashtra v. Videocon Industries Ltd., 2021 SCC OnLine NCLAT 324.
[70] *Supra* note 68.

which will do more harm than good;[71] there are less intrusive, yet effective, alternatives.[72]

C. PRACTICAL IMPLICATIONS — LITIGATION & AGGRAVATED CIRP TIMELINES

The Discussion Paper does not mention how exactly the Code of Conduct will be implemented. This is concerning especially in light of the wordings of some of the duties mentioned in the Code of Conduct. Some of the duties are: maintaining "integrity" in its functioning, maintaining "objectivity" while exercising decisions, refraining from taking "any action that is detrimental to the objectives of the Code," maintaining "transparency in all activities," etc.[73] The implementation of this Code of Conduct will lead to a floodgate of litigation as it will make almost every act of the CoC justiciable through an ambiguous Code of Conduct.[74] Adjudicatory delay was the primary downfall of the previous insolvency law in India.[75] The time elapsed due to legal proceedings is excluded from the CIRP timeline mentioned under Section 12 of IBC.[76] Thus, this Code of Conduct will not only lead to the downfall of the CoC supremacy, but will be a death knell for CIRP.

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[71] *See infra* IV.C.
[72] *See infra* V.
[73] IBBI DISCUSSION PAPER, *supra* note 5.
[74] Zarir Bharucha et. al., *India: Code of Conduct for CoC: Caging the Commercial Wisdom?,* MONDAQ (Oct. 4, 2021), https://www.mondaq.com/india/insolvencybankruptcy/1118082/code-of-conduct-for-coc-caging-the-commercial-wisdomundefined; *Supra,* note 68.
[75] Krishnadas Rajgopal, *Don't let judiciary delays fail IBC: Supreme Court*, THE HINDU (Sept. 13, 2021), https://www.thehindu.com/business/Industry/dont-let-judicial-delays-fail-ibc/article36441200.ece#:~:text=The%20Supreme%20Court%20on%20Monday,the%20Code%20came%20into%20existence.
[76] Committee of Creditors of Essar Steel v. Satish Kumar Gupta, (2019) SCC OnLine SC 1478.

V. THE WAY FORWARD — FINDING THE RIGHT BALANCE

The IBBI must tread with caution as aiming for idealistic circumstances can have serious repercussions. Rather than introducing an over-sweeping Code of Conduct that will prove to be detrimental to the whole CIRP, it can take a two-pronged approach: *First*, IBBI can release a modified Code of Conduct which only contains (non-binding) guiding principles; these general principles should be similar to those mentioned in the previous sub-section of this article.[77] *Second*, IBBI can address some of the serious concerns it has through mandatory requirements that make CIRP more efficient and effective without significantly impacting the autonomy and the commercial wisdom of the CoC to take independent business decisions. The following paragraph briefly lists out a potential set of such mandatory requirements.

1. The IRP can be mandated to explain the guiding principles as mentioned above (modified Code of Conduct) to the CoC in the first meeting [Section 22(1) of IBC];[78] although the CoC may not pay heed to these guiding principles, it may lead to a perspective/behavioural change in the longer term.
2. The CoC can be mandated to provide reasons for the replacement of the IRP or the RP to strengthen their independence and to ensure more efficient CIRP timelines.[79]
3. CoC can be mandated to share the expert reports (such as techno-economic feasibility reports) with the RP and resolution applicants to improve the quality of information available for submitting resolution plans.[80]

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[77] *See supra* IV C.
[78] *See* INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 22(1).
[79] *COC's Role in CIRP Under IBC: Recommendations on Best Practices*, INDIAN INSTITUTE OF INSOLVENCY PROFESSIONALS OF ICAI (Mar. 2021), https://www.iiipicai.in/wp-content/uploads/2021/04/COCs-ROLE-IN-CIRP-UNDER-IBC-RECOMMENDATIONS-ON-BEST-PRACTICES.pdf.
[80] *Id.*

4. The CoC can, in certain circumstances, be mandated to provide interim finance on request of the RP;[81] this is especially when the CD does not have enough cash flows for the RP to manage it as a going concern.
5. It can be mandated that the creditors comprising the CoC have the requisite authority to take on-the-spot decisions;[82] this will prevent wastage of time on taking approvals and make the CIRP timeline more efficient.

The 'creditor-in-control' model is inherent in IBC; a CIRP revolves around the CoC. The SC's concept of 'commercial wisdom' and the concomitant principles further clarifies the nuances involved in the implementation of the same. It is acknowledged that the CoC does not always act in an ideal way; there are some serious concerns that need to be addressed. However, imposing a blanket Code of Conduct is not the way. The two-pronged approach explained in this section can be used by IBBI to streamline its concerns and address them in a more reasonable and acceptable way

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[81] *See* INSOLVENCY & BANKRUPTCY CODE, 2016, *supra* note 1, § 28(1).
[82] Jindal Saxena Financial Services Pvt. Ltd. v. Mayfair Capital Private Limited, (2018) SCC OnLine NCLT 93; SBJ Exports & MFG Pvt. Ltd. v. BCC Fuba India Limited, (2017) SCC OnLine NCLT 20679.

CORPORATE SOCIAL RESPONSIBILITY - A MYTH OR REALITY: A STUDY ON INDIAN PHARMACEUTICAL COMPANIES

Akshata Ramesh[*]

ABSTRACT

*From promoting healthcare to preventive healthcare, the Indian pharmaceutical industry has been proactively focusing on CSR activities since the last couple of years to strategically stay ahead of the curve. From Cipla to Sun Pharma, several Indian pharma giants have been focusing on rural-urban Corporate Social Responsibility ("**CSR**") initiatives and primarily upon promotion of livelihood and health awareness. India is an experienced nation in its strong legacy towards preserving humanity and promoting charity. Over the years the objective has been to contribute to education, health care, community wellness, etc. CSR is a modern and prominent concept in business terminology that most companies employ to develop goodwill and public image. Corporations recognize their profits and acknowledge the need to contribute to the welfare of the society and the interests of their shareholders and members as per their planned strategies. CSR commitments safeguard the interests of shareholders and the general public. For instance, companies employed in non-natural uses of land are directly or indirectly responsible for their acts injuring the environment or the public at large. Hence, companies strategize their objectives to include socio-enviro responsibilities as their CSR initiatives, and build trust and confidence in the society at large. Many however, argue that the CSR notion is a significant oxymoron because of the naturally conflicting environment of the corporation.*

This study will assess the CSR expenditure for the years 2017, 2018, 2019, and 2020 of the chosen four leading Pharma companies. The objective is to study the impacts of CSR initiatives on the financial management and performance of the chosen pharmaceutical companies, especially with the changing narratives in the post-pandemic

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era. Hence, the research problem is to draw a conclusive analysis of whether CSR is a myth or a reality within the pharmaceutical industry in India.

Keywords: Corporate social responsibility, pharmaceutical companies, profits, myth, or reality.

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I. INTRODUCTION: BUILDING BUSINESS RELATIONS WITH THE SOCIETY

Corporations recognize their profits and acknowledge the need to contribute to the welfare of the society and the interests of their shareholders and members as per their planned strategies.[1] CSR commitments safeguard the interests of shareholders and the general public. For instance, companies employed in non-natural uses of land are directly or indirectly responsible for their acts injuring the environment or the public at large. Hence, CSR builds trust and confidence in the company and within the trust as well.[2] Many argue that the CSR notion is a significant oxymoron because of the naturally conflicting environment of the corporation. Several studies have lately acknowledged the obvious shift from philanthropy to strategic CSR by companies witnessing a growth in

[1] M. Sreenivasan & Dr. T. L Reddy, *A Conceptual Study Of The Relevance Of Corporate Social Responsibility In The Pharma Industry*, 8(10) INT'L J. SCI. & TECH. RES. 3111 (2019).
[2] Senthil Vadivu S. & Raja S.S., *Corporate Social Responsibility of Pharmaceutical Companies in India*, 3 (12) INT'L. RES. J. BUS. & MGMT. 15 (2015).

profitability for several companies.[3] However, some companies' financial performances are not affected by higher CSR and yet the company continues to have CSR expenditure.

In recent times, the pharmaceutical industry has grown at a faster pace, given the atrocities of the COVID-19 pandemic. This industry is a direct framework for the welfare of the society by way of patented medicines, life-saving drugs, in consonance with the several prevalent human rights laws.[4] The research paper focuses on analysing the CSR expenditure of 4 leading pharmaceutical firms in India namely **Sun Pharma industries private ltd.[5], Dr. Reddy's Laboratories Ltd.[6], Cipla[7], and Pfizer[8]**. Before analysing these figures, the paper studies the provision under Section 135 of the Companies Act, 2013 and the mandate upon the said companies to comply with CSR responsibilities for the Financial Year 2021 (FY 2021). For the said calculation, the paper uses the net profit, turnover, and net worth of the said companies for the years 2018, 2019, and 2020. The annual reports of the corporations are crucial instruments for analysing corporate disclosures and thereby study CSR expenditures by the company. It is an imperative tool for companies to communicate with their stakeholders, shareholders, and the general public. CSR has therefore been highly regarded as a reliable method equivalent to the audit financial reports.[9]

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[3] Tulsi Jayakumar, *From philanthropy to strategic corporate sustainability: a case study in India*, 37(6) J. BUS. STRATEGY 39-50 (2016).

[4] Susanta Datta & Vinayak Karande, *Strategic CSR through Healthcare: A Case study on Indian Pharmaceutical Companies*, *2*(3) INT'L J. ADV. RES. & INNOVATIVE IDEAS EDUC. 66-74 (2017).

[5] ANNUAL REPORTS PRESENTATION, SUN PHARMA, ANNUAL REPORTS, https://sunpharma.com/investors-annual-reports-presentations/.

[6] ANNUAL REPORTS PRESENTATION, DR. REDDY'S, ANNUAL REPORTS, https://www.drreddys.com/investors/reports-and-filings/annual-reports/.

[7] ANNUAL REPORTS PRESENTATION, CIPLA, ANNUAL REPORTS https://www.cipla.com/investors/annual-reports.

[8] ANNUAL REPORTS PRESENTATION, PFIZER, ANNUAL REPORTS, https://investors.pfizer.com/financials/annual-reports/default.aspx.

[9] C.E Dawkins, *An exploratory analysis of corporate social responsibility and disclosure*, 52(2) BUSINESS & SOCIETY 245 (2013).

In the final analysis of the study, the paper will consider the question of whether CSR is a myth or a reality. The very problematic definition of CSR highlights the ideology that voluntarily conducted activities by companies might be equivalent to independence from legal responsibilities. This explains that there are conflicting interests against and for the promotion of CSR activities in the market. There is indeed very little evidence to support that CSR incentives have been strongly helping corporations to improve their business.[10] Moreover, ethics-based competition amongst companies may also lead to a negative pressure of competition over the CSR activities reinforcing the evident myth about CSR. It is, therefore, crucial to note that complete fulfilment of CSR responsibilities might reap greater benefits for the company such as higher profitability index and efficient brand and goodwill management. Whilst pharma industries, particularly, are expected to alleviate problems relating to health and contribute to environmental sustainability.

Therefore, the paper lays a foundation on the laws concerning CSR as per the respective Indian statute to present a statistical analysis of chosen variables. The paper thereafter attempts to examine the CSR practices of the chosen pharma companies in monitoring and deploying the best investment and risk management mechanisms. The research design adhered to in this research study is <u>conclusive research design using both qualitative and quantitative analysis</u>. This methodology employs to conclude in analysing and selecting the most efficient tools. It is a foundation of statistical analysis and financial variables of the company in constructing a statement of fulfilling the objectives of CSR responsibilities and satisfying the objectives of the research. This study analyses the mandates of CSR, its impact on the company's profitability, including the effect of the COVID-19 pandemic, and in conclusion, answering whether CSR is a myth or a reality.

[10] Deborah Doane, *The myth of CSR*, 3(3) STAN. SOC. INNOVATION REV. 23 (2005).

II. RESEARCH METHODOLOGY

A. SCOPE OF THE STUDY:

Amidst the aggressive impact of the COVID-19 pandemic in India, enhancing CSR and contribution to healthcare has become greatly crucial for all healthcare companies. The study is indeed a distinctive and innovative one as it offers a strategic and systematic overview of CSR and its correlation with financial performance elements, myths, and realities. The study would help businessmen, policymakers, and other corporate players within the pharmaceutical industry. The scope for the study is restricted to the quantity and quality of CSR expenditures and the chosen financial indicators like profit after tax. There is a scope for further research in correlating CSR with the stock market with the help of regression analysis and stock analysis. As of 2021, India suffers from unsatisfactory investment in research & development ("**R&D**"), and infrastructure in the global sector mapping both traditional and novel industries. This highlights the scope for building enhanced acceptance for innovation in this field with extensive research.

B. SOURCES OF DATA:

The research utilizes secondary data and financial data including profit and loss statements, balance sheets, and relevant statistics taken from annual reports and online websites of the four companies. The statistical methodology utilizes a sample in examining the estimates of the data in hand. The secondary data predominantly includes official journals and websites published, such as the Ministry of Finance, the government department of statistics, economic boards, and companies' official websites.

C. METHOD OF ANALYSIS:

<u>The Research utilizes both qualitative and quantitative methods with secondary data analysis.</u>

> ***Firstly,*** CSR expenditures of Sun Pharma industries private ltd., Dr. Reddy's Laboratories Ltd., Cipla, and Pfizer from FY 2017-18, 2018-2019 & 2019-2020 are utilized to estimate the CSR expenditure for FY 20-2021. **The average net profit from FYs 2018, 2019, and 2020 of the 4 firms is computed. 2% of this Average net profit will provide the eligibility of the companies to spend mandatorily on CSR activities under Section 135**[11] of the Companies Act, 2013.
>
> - The paper will also include the CSR budget, CSR spent for the years ending 2017, 2018, 2019, and 2020 for the four companies to understand the trends employed by pharma companies.

> ***Secondly,*** the study uses the **correlation** method to examine the **correlation** between variables CSR expenditure (X) and profit after tax (PAT)(Y1), earning per share (EPS)(Y2), and return on assets (ROA)(Y3) of the four above-mentioned pharmaceutical companies. Data has been collected by a careful analysis of the official annual reports of the companies available in the public domain, websites, for FY ended March 2016 to 2020 with the help of a Microsoft excel sheet. Necessary findings and conclusions have been made accordingly.

D. LIMITATIONS:

The study is based on basic and generic understanding. A perfect picture of the company's future financial status cannot be drawn with the help of the method utilized in this paper. It exclusively depends upon published data found online which is limited and has a restricted view of the financial state of the company. The study incorporates data over 4 years from 2017 to 2020 and therefore does not represent the entire state of the financial health of the company and in no way reflects on the state of the company. The study is hindered further by the researcher's limited understanding of a seemingly vast topic that is the CSR concept.

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[11] Companies Act, 2013, Act No. 18 of 2013, § 135 (Ind.).

III. DATA ANALYSIS AND INTERPRETATION

In comparison to the other core industries in India, the pharmaceutical industry is always under the public lens concerning its operations and expenditure, especially amidst this global pandemic. Medicines and related services produced by the pharmaceutical companies are important aspects of delivering enhanced and effective health care services which are a crucial part of the CSR by the companies. The following data has been collected concerning the topic at hand:

A. ESTIMATION OF CSR EXPENDITURES AS PER THE LEGAL MANDATES:

As per **Section 135 of Companies Act, 2013,**[12] "Every company which has:

1. The net worth of rupees five hundred crores or more, or

2. Turnover of rupees one thousand crores or more or

3. A net profit of rupees five crores or more,

during (the immediately preceding financial year) shall constitute a Corporate Social Responsibility Committee. As per clause (5) "the Board of every company referred to in sub-section (1), shall ensure that the company spends, in every financial year, at least 2% of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its CSR Policy".

The average net profit from Financial Years 2018, 2019, and 2020 of the 4 firms is computed. 2% of this Average net profit will provide the eligibility of the companies to spend mandatorily on CSR activities under Section 135.

[12] *Id.*

***Table A (in millions)**

Name of the pharma company	**FY 2017-18 (mil) (A)**	**FY 2018-19 (mil) (B)**	**FY 2019-20 (mil) (C)**	**Estimated CSR expenditure = [(A+B+C) / 3] × 2%**
Sun Pharma Industries pvt. ltd	26,337.9	26,654.2	37,649.3	90,641.4 / 3 × 2% = **604.276 mil**
Dr. Reddy's Laboratories Ltd.	9468	19,500	20,260	49,228 / 3 × 2% = **328.186 mil.**
Cipla	1,419.35	1,509.61	1,546.98	4475.94 / 3 × 2% = **29.8396 mil.**
Pfizer India	3600.7	4290.5	5091.3	12,982 / 3 × 2% = **86.55 mil.**

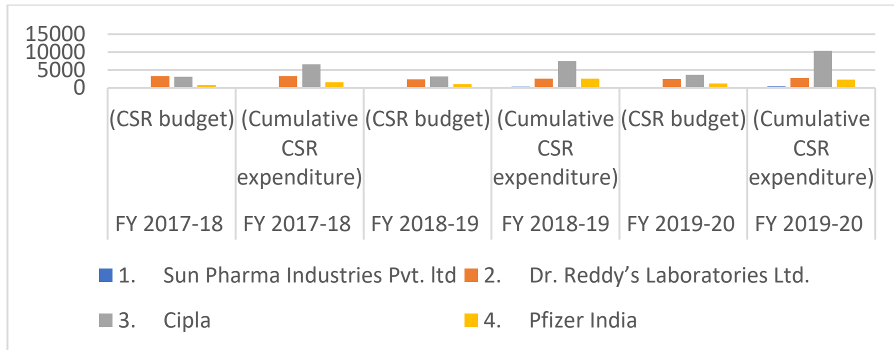
- **In Table A,** A, B, and C are the net profit values for FY ending 2018, 2019, and 2020 respectively for the four selected pharma companies.
- **Variable A, B, and C** i.e. the net profit includes all profits arising from consolidated P/L statements. It is important to estimate the already unpublished FY 2021 CSR expenditure according to the new amendments to the Companies Act, 2013. The Companies (CSR Policy) Amendment Rules, 2021 ["**2021 Amendment**"] lays down a list of CSR activities included in the CSR policy for the companies.

***Table B (in Lakhs)**

Name of the pharma company	FY 2017-18 (CSR budget)	FY 2017-18 (Cumulative CSR expenditure)	FY 2018-19 (CSR budget)	FY 2018-19 (Cumulative CSR expenditure)	FY 2019-20 (CSR budget)	FY 2019-20 (Cumulative CSR expenditure)
Sun Pharma Industries Pvt. ltd	0*	26.97	0*	393.6	269.9	437.1
Dr. Reddy's Laboratories Ltd.	3279.23	3281.16	2363.6	2616.29	2449.4	2753.08
Cipla	3105	6552	3214	7445	3624	10343
Pfizer India	822.18	1,590.52	1,047.74	2,607.31	1217	2344

**** Since, the average net profit of the Company for the last three financial years was negative, the Company was not required to spend on CSR activities during the previous year. However, the Company has voluntarily spent on CSR activities***

- **Table B** is the values of the CSR budget versus the CSR expenditure of the four chose pharma companies. These pharma giants have spent more than the amount prescribed for CSR in a financial year. *The following is a graphical representation of the same:*



- According to the above graph, the CSR expenditure budget and actual expenditure for 2017-18, 2018-19, 2019-20 has been depicted. This interpretation is important to analyse the excess amount utilized for CSR by the companies. Essentially, the expenditure is more than the set budget for every company for all the respective financial years.
- According to the 2021 Amendment, Rule 7(3) explains a situation where a company spends an excessive amount of CSR budget in a FY. Such extra amount i.e., more than the prescribed 2% of average net profit from the preceding 3 FYs, shall be set off against the need for CSR expenditure under Section 135 up to the next 3 FYs, subject to certain conditions (Goyal C. D., 2021). This surplus shall not be a part of the profits and be utilized within 6 months from the end of the FY.

B. CORRELATION

**Table C.1 – Sun Pharmaceuticals Ltd.*						
Financial Year	CSR Expenditure (X)	EPS (Y1)	PAT (Y2)	Total Assets	ROA (Y3) - Net income / Total Assets (%)	Correlation (calculated on Micro. Excel)
2015-16	116.54	29	45,457	5,55,302.70	6.38	
2016-17	24.09	9	69,644	6,14,102.40	4.98	**(X/Y3)=0.733905071**
2017-18	26.97	8.7	20,957	6,43,028.00	3.99	**(X/Y2)=0.065626163**
2018-19	39.36	11.1	26,654	6,46,938.10	4.78	**(X/Y1)=0.985521861**
2019-20	43.71	15.7	37,649	6,82,524.60	6.13	

****Table C.2 – Dr. Reddy's Laboratories Pvt. Ltd.***						
Financial Year	**CSR Expenditure (X)**	**EPS (Y1)**	**PAT (Y2)**	**Total Assets**	**ROA (Y3) - Net income / Total Assets (%)**	**Correlation (Calculated on Micro. Excel)**

2015-16	**412.02**	**793.9**	**21,306**	**2,07,650**	**10.26**	
2016-17	**426.65**	**835.1**	**12,921**	**2,19,821**	**5.87**	**(X/Y1)= -0.3296471**
2017-18	**328.11**	**341.7**	**9468**	**2,25,604**	**4.196**	**(X/Y2)= -0.2269673**
2018-19	**261.62**	**769.2**	**19,500**	**2,25,427**	**8.65**	**(X/Y3)= -0.0971093**
2019-20	**275.3**	**1769**	**20,260**	**2,32,241**	**8.72**	

****Table C.3 – Cipla***						
Financial Year	**CSR Expenditure (X)**	**EPS (Y1) (**	**PAT (Y2)**	**Total Assets**	**ROA (Y3) - Net income / Total Assets (%)**	**Correlation (calculated on Micro. Excel)**
2015-16	**318.8**	**18.76**	**13,834.20**	**211281.8**	**6.54**	
2016-17	**573.9**	**12.52**	**10,354.20**	**210370.7**	**4.92**	**(X/Y1)= 0.260720003**
2017-18	**665.2**	**17.53**	**14,165.70**	**228605.5**	**6.19**	**(X/Y2)= 0.419787535**
2018-19	**744.5**	**18.97**	**14,924.40**	**239633.2**	**6.22**	**(X/Y3)= 0.075499498**
2019-20	**1034.3**	**19.19**	**14,995.20**	**236625.6**	**6.33**	

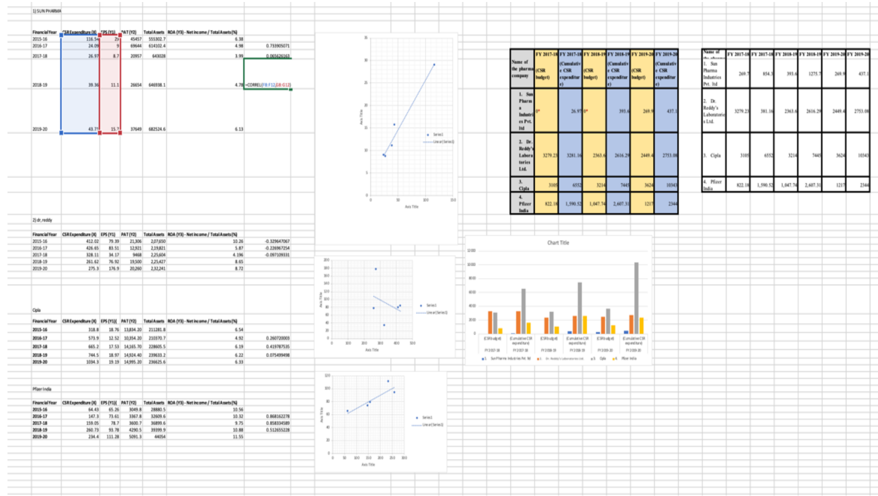
****Table C.4 – Pfizer India***						
Financial Year	**CSR Expenditure (X)**	**EPS (Y1) (**	**PAT (Y2)**	**Total Assets**	**ROA (Y3) - Net income / Total Assets (%)**	**Correlation (calculated on Micro. Excel)**
2015-16	**64.43**	**65.26**	**3049.8**	**28880.5**	**10.56**	

2016-17	**147.3**	**73.61**	**3367.8**	**32609.6**	**10.32**	**(X/Y1)= 0.86816228**
2017-18	**159.05**	**78.7**	**3600.7**	**36899.6**	**9.75**	**(X/Y2)= 0.85833459**
2018-19	**260.73**	**93.78**	**4290.5**	**39399.9**	**10.88**	**(X/Y3)= 0.51265523**
2019-20	**234.4**	**111.28**	**5091.3**	**44054**	**11.55**	

Based on the information evaluated in Table C1, C2, C3, and C4, the following correlation table is prepared to easily understand the relationship between CSR and EPS, PAT and ROA by the four companies.

***Table D**			
Company	**CSR and EPS**	**CSR and PAT**	**CSR and ROA**
Sun Pharmaceuticals Ltd.	0.985521861	0.065626163	0.733905071
Dr. Reddy's Laboratories Pvt. Ltd.	-0.3296471	-0.2269673	-0.0971093
Cipla	0.260720003	0.419787535	0.075499498
Pfizer India	0.86816228	0.85833459	0.51265523

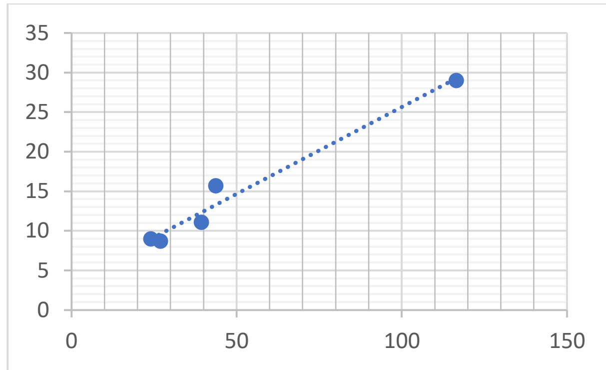
The excel work-log extract for the correlation analysis is as follows:



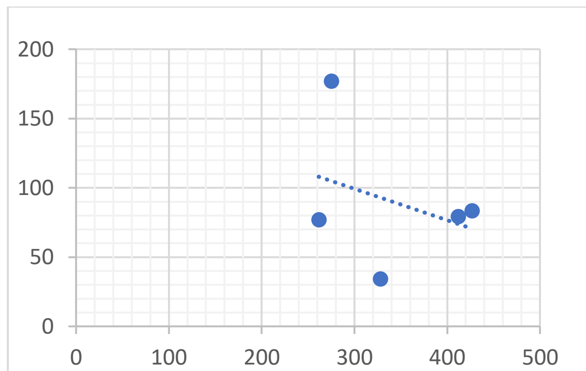
- It is now evident that CSR is a crucial element in enhancing the performance of the company. Here in Table D the correlation for each firm has helped the researcher analyse the importance of CSR and its impact on the different variables. The correlation between CSR and EPS is negative only in the case of Dr. Reddy's Laboratories Pvt. Ltd **(~0.32).** This indicates that a higher level of CSR reduces the EPS of the company.

  Therefore, it can be safely stated that there is a strong positive correlation between CSR and EPS.

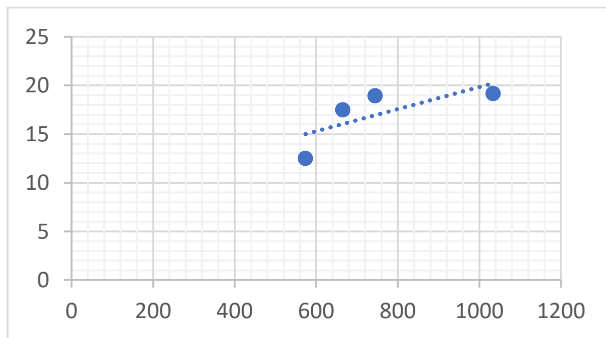
A



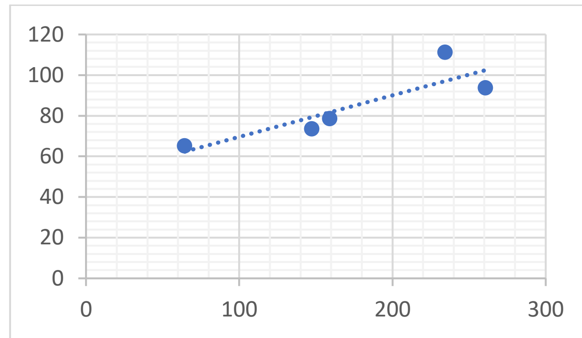
B



C



D



- Series A explains the positive correlation between **CSR and EPS** in Sun Pharma. This means that, as the CSR expenditure increases the ESP also increases. A higher EPS would indicate that the investors are willing to pay a greater amount for the shares of the company, given their perception of the higher net profits and share price. A similar indication is seen from series C (Cipla) and series D (Pfizer) with a strong positive correlation of ~0.26 and 0.86 respectively.
- A similar observation is made in the correlation between **CSR and PAT** in the three companies except for Dr. Reddy's Lab Pvt Ltd. The objective here is to analyse that there is a strong correlation between CSR and the profits of the company. It is also observed that the companies having greater expenditure on CSR have a significant increase in net profits, whereas, in the case of Sun Pharma and Dr. Reddy's lab, the correlation is less than 0.5 and 0 respectively identifying the fluctuating net profits of the companies.
- **ROA** is greatly used as a proxy for the profitability of the firm. To examine the problems here, the **CSR** is negatively correlated with ROA in the case of Dr. Reddy's Lab which can be inferred to the soundness, fairness, and profitability of the firm. Consumer protection can be assumed to be having a negative correlation here as an aegis under ROA/profitability. However, in a general observation, an increase in

CSR expenditure has a positive increase in the growth and profitability of the company i.e. ROA.

A negative correlation thus leads us to examine the myths and realities of CSR in the further chapters.

IV. DISCUSSION

A. IMPORTANCE OF STRATEGIC CSR

- Over the past several years, the pharmaceutical industry in India has gained prominent growth in the international as well as domestic market.[13] The contribution of made-in-India medicines in the global pharma industry has become an expedient uprise and many Indian companies have now become global giants.
- It can also be inferred that a transition from voluntary CSR involvement to mandatory obligation has strategically led to a successful business as well as upliftment of the society.[14] To maximize wealth and business growth, companies are focussing on community development and economic growth of the country with the help of CSR activities such as in fields of education, healthcare, livelihood, infrastructure, and more. Based on recent studies,[15] it is observed that the CSR budget has been focussing on expenses towards healthcare, sanitation, and livelihood by several companies. Because the press and the general public are increasingly interested in the kind of healthcare service being provided, pharmaceutical firms generally avoid being drawn into its debate.

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[13] Arvind Sahay, *India can become the pharmacy of the world,* THE HINDU BUSINESSLINE (May 07, 2020), https://www.thehindubusinessline.com/opinion/india-can-become-the-pharmacy-of-the-world/article31516558.ece.
[14] Simran Kaur & Nidhi Tandon, *The Role of Corporate Social Responsibility in India, 6*(3) RES. J. COMM. & BEHAV. SCI., 29 (2017).
[15] Prakash Rao et al., *Role of CSR Expenditure in Health Care*, 10(5) INDIAN J. PUB. HEALTH R & D*,* 713 (2019).

- From the data analysed in **Table B** in the previous chapter, it is evident that given the negative amount of average net profit from the preceding 3 years, **Sun Pharma** did not have a CSR budget formulated (according to the policy) in 2017-18 and 18-19. This loss of net profits did not stop the firm from doing voluntary CSR activities. The DRF i.e. **Dr. Reddy's Foundation** is a Non-Profit Organisation focusing on strategic CSR activities for helping improve livelihood and giving opportunities to the youth to complete their education. Moreover, CSR practices may be included within the agency costs which can be a socially complicated relationship that hinders a company's goodwill and focuses more on the individual image. This hampers the stance of shareholders in the company's management.
- Some pharma companies are however concentrating on getting highly expensive medications to market while devoting more resources and time to drug development.[16] CSR has been regarded as a proposed solution to market failure.[17] A negative CSR has a stronger effect on the company's evaluation and performance than a positive CSR. Any generalized conclusions regarding the negative correlation between CSR and ROA, PAT, and EPS cannot be a conclusive statement that CSR negatively impacts their output in financial performance.[18]

B. CSR - ENVIRONMENTAL SUSTAINABILITY AND TACKLING COVID-19

On 22nd January 2021, the Ministry of Corporate affairs (MCA) introduced the Companies (Corporate Social Responsibility Policy) Amendment Rules, 2021, amending its predecessor rules of 2014. Notably,

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[16] A. Janga, *CSR in Pharma industry - review on India and USA,* 8(1) INT'L J. PHARM. & BIOLOGICAL SCI. 363 (2018).

[17] Geoffrey Heal., *Corporate social responsibility: An economic and financial framework*, 30 GENEVA PAP. RISK INS., 387 (2005).

[18] Mari Kooskora et. al, *The Relationship Between Corporate Social Responsibility and Financial Performance (A case study in Finland)*, in SOC. RESP. & SUSTAINABILITY, WORLD SUSTAINABILITY SERIES, 471 (W. Leal Filho ed., 2019).

under Rule 12 (Definition) the following important changes were made in this regard:

- The definition of ***administrative overheads*** includes expenses incurred for general management and administration of CSR initiatives and hereby excludes any expense directly incurred from designing, implementing, monitoring & evaluation of such initiatives.
- Importantly, CSR would now include activities of mundane nature of the company activities, provided that such activities include R & D of upcoming drugs, medicines/medicinal devices or vaccines relating to COVID-19 for FYs 2020-21 to 2022-23 (subject to fulfilment of specified conditions).

  Companies align themselves with industrial, economic, responsible, and sustainable practices and activities, to embody transparency and maintain goodwill. Community positively pressures companies to evaluate good CSR equity and practices especially with their operations; and in the case of the pharma industry, companies ensure sustainability and environmental preservation in their operations.
- **Sun Pharma's** product ranges and environmental programs are distinguished by innovation specialization. They strive to invest more in technology focused on an all-encompassing EHS (Environmental, Health, and Safety) strategy that they had already implemented to manage and direct their projects. In 2019, they also started focusing on waste management and started publishing business responsibility report with a detail environmental impact assessment in the public domain. This has greatly influenced its profitability over the past five years.

  The company has vividly helped citizens during the outbreak of COVID-19. It has done specific donations such as for medicines, hand sanitizers, and PPE across the country as well as internationally i.e. Rs. 250 million of hydroxychloroquine and other drugs. This promise of producing COVID specific drugs has *however not been available in the public domain* or is producing help during this time. However, the company has started phase II trials of its innovative approach on the treatment of COVID and new medicines for the same.

- **Dr. Reddy's Lab** has been focussing on environmental stability in their sustainability report since 2012. From Rs. 621 to 728 million, the company has been investing in enhanced environmental protection measures as a part of its CSR policy.
  Amidst the pandemic, the company has extended its health insurance coverage to ₹0.3 million and has greatly focused on AI and technological developments to help the community.
- **Cipla** Limited, a multinational pharmaceutical firm based in India (Mumbai), spent Rs. 363.1 million in FY 2019-20. Countless lives have been significantly enriched by CSR funding on numerous developmental projects in the fields of healthcare, training, education, and disaster management across India.
  Pfizer Limited's CSR programs are deliberately chosen to assure that they are innovative, flexible, and long-term, as well as fully aligned with their international commitment to be accepted as a responsible company by the community. These programs are judged on their uniqueness, feasibility, and extensibility, as well as their strategy and solution to handle a critical healthcare issue like COVID-19 and shortage of medicines and drugs.

C. THUS, IS CSR A MYTH OR REALITY?

1. Myths About CSR:

There is indeed a huge strain on declining environmental assets owing to economic development and population growth, and this contributes to environmental destruction on the one hand.

- ***The most common myth*** about CSR is that it is an independent element of economic growth and financial performance. From the data analysed in this study, it is not conclusively true that CSR does not affect the economic growth and financial performance of the company. It must be highlighted alongside the study conducted in Table D, there

seems to be a strong and real relationship between the ROA and CSR that is often neglected in the market.[19]

- ***Another myth*** **is that CSR can influence government policies** and often multinational pharma companies in reality only use a minute amount of their profits as CSR expenses.[20]
- ***It is also*** often **assumed** that **developed countries lead CSR activities.** There seems to be multiple instances of developing nations demonstrating their potential to execute the so-called triple bottom line of sustainability, i.e., social, economic, and ecological advantages that are integrated and interconnected.[21]
- The market has a potential to provide both financial returns and social gains; however, consumers are often focused on personal long-term benefits in maximising their self-interests. In essence, consumers are influenced largely by price, sales & quality of products/services.[22]
- It is also observed that in competing to create an external picture of goodwill and responsible behaviour, companies tend to lay a blanket upon the socially irresponsible behaviour, in both internal and external environments. This may include lobbying activities, tax evasion/avoidance etc.

Therefore, as discussed previously, CSR is a crucial element in enhancing the performance of the company and the biggest myth about CSR is that it is not related to economic growth. It is clear that GDP and quality of life are aligned together and expansion of businesses in India are crucial for economic growth.[23]

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[19] CSR strategy, *10 Myths About CSR Strategy*, ONEREPORT, https://one-report.com/10-myths-corporate-social-responsibility-strategy/.

[20] Anupam, *CSR: Myths and Reality*, 1(2) THE CATALYST - J. OF MGMT., 58 (2017).

[21] L. Cresenta Shakila Motha et al., *The moral calculus of pharma companies in India,* 9(2) ASIAN J. PHAR. & CLINICAL RES. 30 (2016).

[22] *Supra* note 10.

[23] Wayne Visser, *CSR Myths, Popular misconceptions on CSR*, MIKADO BLOG, (Aug.7, 2009), https://www.mikadoconsulting.com/blog/16/csr-myths-popular-misconceptions-on-corporate-sustainability-and-responsibility.

2. <u>REALITIES OF CSR:</u>

- The **reality** however behind CSR is ***first,*** the lack of awareness of external players in the market. Moreover, for smaller enterprises, it is greatly difficult to initiate larger CSR activities and policies.
- ***Second,*** numerous executives regard CSR as yet another task to complete. They argue that they've had to contend with quality problems (and, in certain circumstances, quality assurance compliance), health and safety laws, and plenty of other legally allowed criteria. They emphasize the importance of devoting a substantial period to audit, examination, and preparation.
- ***Third,*** most CSR management would readily confess to conflicts and a lack of communication amongst CSR management and procurement departments. Of course, the cost is a consideration, so it is clear that companies dealing with CSR seek appropriate CSR practices, high quality, on-time delivery, and a low cost.
- ***Moreover,*** many argue that corporations can take up CSR because they are one of the handfuls of private companies with the financial means to do so. These large corporations therefore tend to focus more on the competitive argument, that addressing social issues may hamper their position in the market in comparison to other businesses.

  On the other hand, smaller companies face shortage of funds to engage in CSR as such expenses may hamper their short-term financial returns. The problem arising here is that companies are worried about creation of goodwill and profitability, over solving societal problems and helping the society.[24]

Therefore, companies must put a few of their financial and human resources to good use in efforts to improve and safeguard the environment and society standards at large.

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[24] Akshit Maheshwary, *CSR Responsibility: A myth or reality?,* TAXGURU (Jan. 02, 2018), https://taxguru.in/company-law/csr-responsibility-myth-reality.html.

V. FINDINGS AND CONCLUSION

IT CAN THEREFORE BE OBSERVED THAT:

Although some CSR advocates argue that companies that practice CSR are much less likely to exploit employees and economies, particularly in developing countries, critics argue that CSR introduces external ideals on local populations, with unexpected consequences.[25]

- Some critics believe that corporations' CSR systems are mostly intended to divert public attention away from ethical considerations of their operational activities. They argue that CSR firms earn competitive advantages, and support the ideology of promotion of liberalisation over environmentalism, labour support and public health measures.[26]
- Pharmaceutical companies and their operations are inextricably connected to the betterment of the general public, and their investment decisions have a significant effect on human well-being, necessitating CSR. Such companies have indeed been criticized for charging exorbitant rates for life-saving drugs and for being reluctant to respond to the plight of the people.[27]
- Companies are the most effective means of attributing community needs by providing social solutions, therefore CSR is beneficial. By this vantage point and the study conducted in previous chapters, there are some explanations why a community might want companies to serve as instruments and provide effective CSR representatives.

  Firstly, companies that follow more socially appropriate policies will have much more satisfied clients, staff, and shareholders, and will therefore last indefinitely and succeed under more challenging

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[25] Wendy J. Werner, *Corporate social responsibility initiatives addressing social exclusion in Bangladesh*, 27(4) J. HEALTH, POPULATION, & NUTRITION 545 (2009).

[26] S. Ganguly, *The Investor-State Dispute Mechanism (ISDM) and a Sovereign's power to protect public health*, *38* COLUM. J. TRANSNAT'L L. (1999).

[27] Klaus M. Leisinger, *The corporate social responsibility of the pharmaceutical industry: Idealism without illusion and realism without resignation*, *15*(4) BUS. ETHICS *Q*, 577 (2005).

situations. In previous studies,[28] it is evident that most consumers are responsive to the social position of the products/services of the companies. Moreover, there is a strong correlation between employee satisfaction and CSR activities of the companies. ***Secondly,*** companies have more expertise than individuals and governments, and thus are better able to use that knowledge to cater goods and services towards the right audiences. Companies regularly conduct active research to truly comprehend and respond to the expectations of their key parties, customers, and stakeholders.

IN SUMMING UP:

A significant assumption related to CSR is that firms follow what society needs and do not essentially exploit society for their benefits. It is natural for entities to be drawn towards solving issues in society including health, environment, and education. Yet, goodwill is always preferred over public shaming, and the CSR trend includes positive rewards such as loyal customers, brand reputation, positive public responses and fulfilling shareholders expectations[29]. Especially in times of economic crisis and health hazards, many organizations are attempting to reduce their expenses and investments to stay afloat. Small companies see social events as a roadblock that reduce their short-term financial returns. Due to the lack of governmental regulation, businesses have full freedom to implement corporate responsibility as they see fit.

As drug discovery is becoming costlier every year, many Indian companies struggle to afford investment in R&D making it difficult for them to focus on CSR. Some companies therefore alternatively start R&D into drug adjacent fields like drug delivery, marketing & distribution etc. Here, it is often observed that several Indian pharma companies join hands,

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[28] Timothy M. Devinney, *Is the Socially Responsible Corporation a Myth?,* 23(2) ACAD. OF MGMT. PERSP. 44 (2009).

[29] Dow Scott et al., *The Role of Rewards Leaders in CSR and Sustainability*, 29(2) WORLD WORK J. 8 (2020), *retrieved from* LOYOLA E COMMONS, SCH. OF BUS.: FAC. PUB. & OTHER WORKS (2020).

collaborate, expand and strengthen value chain with other multinational corporations, for example Zydus, Biocon etc sign deals with bigger companies such as Novartis. With such collaborations/mergers & Acquisitions, companies can not only enhance profitability, but also strengthen their CSR investments.

ZEE-INVESCO DISAGREEMENT REGARDING EGM REQUISITION: A MISSED OPPORTUNITY FOR SHAREHOLDER ACTIVISM?

Abhijeet Chaudhary & Ritam Khanna[*]

ABSTRACT

Shareholders enjoy a wide array of rights in relation to the company and have the ability to take over the managerial control over the company and put forth the demand every – now and then. Post-2017, Indian shareholder activism has empowered members to propose an overhaul of the board without any inertness to their interest and financial stake in the companies. The present write-up delves into one such murky dispute of the shareholder activism and non-compliance with laws and regulations, between Zee Entertainment Enterprises Ltd. and two of its largest shareholders, Invesco Developing Markets Fund & OFI Global China Fund LLC. One being an Indian Media giant and the other two being substantial foreign investors in India, have collectively flagged the timeline with an aggressive precedent and it needs to be seen if their move of activism turns out favourable or not. It critically analyses whether the legality of the proposed resolutions is to be considered for deciding whether such meetings can be called or denied in the light of the reasoning of the Hon'ble Bombay High Court and gives a comparative view on the similar jurisprudence of the United Kingdom. Further, it sheds light on the loopholes and a need for amendment in Section 100 of Companies Act 2013 with differentiation in interpretation of sectorial regulations that have affected the rights of shareholders in the current dispute.

Keywords: Extraordinary General Meeting, Requisition, Shareholder Activism, SEBI Regulations.

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I. 2021 – A YEAR OF RATTLING CAGES OF SHAREHOLDER ACTIVISM

According to the Activist Insight report on Governance,[1] the Asia region has experienced a wave of shareholder activism since 2017 which is continuing to grow. It can be seen that financial matters are being viewed under the microscopic lens of managerial capability and shareholder activism. In the year 2021, the most prominent targets were the issue of the managerial appointments made to the board instead of all the major financial and overturning issues relating to the divestitures or mergers.[2] In 45 companies, these issues were remedied either with the help of *meetings* or *engagement* between the management and shareholders.[3] In the other moves of activism, the *shareholder-favourable seats* through a settlement in midst of an ongoing proxy or an appointment battle is another strong trend emerging in Asian countries. It can be considered a rite of passage for any economy undergoing governance reform. Back in the UK during 1995, similar activism was seen in opposition to the executive remuneration hikes and

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[1] Activist Insight, *Shareholder Activism in 2021: Asia- Pacific Overview*, https://www.activistinsight.com/resources/reports/.
[2] *Id.*
[3] *Id.*

holders hit back with the privatized utility companies followed by a staff reduction and pay restraints for staff in such companies.[4]

India has seen uncertainty in the vision of activism with the executive committees fixing higher and competitive compensation schemes.[5] Recently, Eicher Motors Managing Director was ousted with a denied pay and post by the shareholders in their AGM.[6] Yes bank, which is one of the largest Indian private sector banks with at least 25% of the equity in Dish TV, demanded the EGMs to replace the entire board of the company.[7] Following a ripple effect with the large foreign fund owning almost 18 per cent of the company asking for an EGM to replace the promoter.[8] With a volatile and sensitive market as that of India, the shareholders and the Board tussle in order to secure their respective interests must not scuffle the procedural and substantive rights of opposite sides. Most of such disputes are matters of indoor management and are rarely subjected to judicial scrutiny.[9]

Taking one such tussle which landed at the Judicature of Hon'ble Bombay High Court ("**HC**")– ***Zee v. Invesco***, the present paper aims to

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[4] CONFEDERATION OF BRITISH INDUSTRY, DIRECTORS' RENUMERATION: REPORT OF A STUDY GROUP CHAIRED BY RICHARD GREENBURY AT 35 (July 17, 1995) (UK).

[5] Bhaswar Kumar, W*hy is India Inc seeing a surge in shareholder activism?,* BUSS. STD. (Oct. 4, 2021), https://www.business-standard.com/podcast/companies/why-is-india-inc-seeing-a-surge-in-shareholder-activism-121100400363_1.html.

[6] *Eicher's shareholders rejected MD's re-appointment over salary hike: Report*, **BUSS. STD**. (Aug. 20, 2021), https://www.business-standard.com/article/news-cm/eicher-motors-shareholders-reject-siddhartha-lal-s-re-appointment-as-md-121082000583_1.html.

[7] Dev Chatterjee, *Yes Bank gets tough on DISH TV promoters, calls EGM to replace firm's board,* BUSS. STD. (Sept. 23, 2021), https://www.business-standard.com/article/companies/yes-bank-gets-tough-on-dish-tv-promoters-calls-egm-to-replace-firm-s-board-121092301353_1.html.

[8] Dev Chatterjee, *Dish TV vs Yes Bank battle: A matter of principle for both companies,* **BUSS. STD**. (Dec. 7, 2021), https://www.business-standard.com/article/companies/against-an-aggressive-yes-bank-dish-tv-may-opt-for-out-of-court-settlement-121120601427_1.html.

[9] Sakate Khaitan et al., Shareholder Activism in India: Overview, THOMAS REUTERS: PRACTICAL L. (Oct. 1, 2020), https://uk.practicallaw.thomsonreuters.com/w-013-9526?transitionType=Default&contextData=(sc.Default)&firstPage=true.

understand the treatment of shareholder activism under the judicial lens.[10] The issues arose when the Board of Directors ("**BoD**") of Zee Entertainment Enterprises Limited ("**Zee**"), a listed company refused to call an extraordinary general meeting ("**EGM**") upon receiving a request for such a meeting from Invesco Developing Markets Fund and OFI Global China Fund LLC (collectively, **Invesco**) who are two of the biggest institutional shareholders of Zee holding an aggregate of 17.88% of the paid-up share capital of Zee carrying voting rights.[11] The requested EGM was to remove Zee's Managing Director ("**MD**") and Chief Executive Officer ("**CEO**") i.e., Mr. Punit Goenka, remove two other directors and appointment of six named individuals as independent directors.[12]

Zee's Board of Directors ("**BoD**") refused to call the EGM as it scuffled the procedural and substantive rights of the BoD and lead to contraventions that would term the requisition illegal. The parties discussed at length possible contraventions and flaws under the purview of the Companies Act 2013 ("**the Act**"), SEBI (Listing Obligations and Listing Requirement) Regulations 2015 ("**SEBI LODR**"), Ministry of Information and Broadcasting-Policy Guidelines for Up linking of Television Channels from India ("**MIB guidelines**"), Competition Act, 2002[13] and SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 2011 ("**SEBI Takeover Code**") which ultimately targeted the legality of the requisition.[14] The same is being analysed in Part II of the paper. Under the Part III of

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[10] Zee Entertainment Enterprises Ltd. v. Invesco Developing Markets Fund and Others., SUIT (L) NO. 22522 OF 2021.

[11] Press Release, *Disclosure under Regulation 30 of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended from time to time*, ZEE ENTERTAINMENT LTD. (Sept.13, 2021), https://assets.zee.com/wp-content/uploads/2021/09/14115357/SEIntimation130921.pdf.

[12] *Id.*

[13] Competition Act, No. 12 of 2003, §6 (Ind.).

[14] Press Release, *Disclosure under Regulation 30 of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended from time to time*, ZEE ENTERTAINMENT LTD. (Oct. 1, 2021), https://assets.zee.com/wp-content/uploads/2021/10/01142720/SELD01102021.pdf.

the paper, the discourse relates to the Zee – Invesco dispute and analyses the reasoning and arguments of both parties to the dispute and the critical fallacies of adjudicating authorities. The analysis also goes on to show the comparative view of the legality of requisitions in the United Kingdom and other common law countries which concludes the threshold of the illegality of such requisitions (Part IV). Part V of the paper discusses how the present instance is a rare sighting of an aggressive strategy of shareholder activism, which more often than not opposes the efforts of the rights and co-managing capacity of the shareholders in the activism situation. The paper concludes with opinions on the present case and adjudges the scope of aggressive shareholder activism in India.

II. BEGINNING OF ZEE-INVESCO'S PUBLIC TUSSLE

Section 100(2)(a) of the Companies Act, 2013 paves way for shareholder activism by empowering shareholders holding at least 10% of the paid-up share capital of the Company to demand the BoD for an EGM and propose resolutions for the same.[15] Section 100(3) further provides that such a request letter shall contain the matters to be discussed at the proposed meeting, shall be signed by the requisitioning shareholders and shall be delivered at the registered office of the Company.[16] Additionally, if within 21 days from the receipt of a valid requisition, the BoD does not take any steps to call the requested EGM within 45 days from the date of receipt of such requisition, then Section 100(4) permits the requisitioning shareholders to call and hold the EGM themselves within 3-months from the date of such requisition.[17] Therefore, this provision enables shareholders to come forward and participate in the functioning of the company. Invesco sent a request letter to Zee's BoD on 12 September 2021 demanding an EGM and proposing resolutions for bringing a change in

[15] Competition Act, No. 12 of 2003, §100(2)(a) (Ind.).
[16] Competition Act, No. 12 of 2003, §100(3) (Ind.).
[17] Competition Act, No. 12 of 2003, §100(4) (Ind.).

Zee's management after meeting all the procedural requirements in Section 100.[18]

Now, though Zee's BoD had 21 days i.e., till 3 October 2021 to call the EGM, Invesco approached the National Company Law Tribunal ("**NCLT**") Mumbai bench under Section 98 and 100 of the Act, on 29 September 2021 itself, seeking a direction to Zee to conduct the EGM.[19] NCLT in the matter of ***Invesco Developing Markets Fund & Ors. v. Zee Entertainment Enterprises Limited***,[20] on 30 September 2021 ordered Zee to favourably consider the request for EGM and directed it to act in consonance with Section 100 of the Act. As per the order, the BoD did consider the request letter but refused to call the EGM because of the illegality of the proposed resolutions.[21] Without wasting any time, Zee filed a suit in the Hon'ble Bombay High Court for declaring that the request letter is invalid, declaring that Zee's decision to not call the requested EGM was valid and sought an injunction against Invesco to prevent it from doing anything in pursuance of the request letter.[22] Before the Hon'ble HC heard Zee's petition, the NCLT vide order dated 5 October 2021 gave Zee 2 days i.e., till 7 October 2021, to file a reply to the application filed by Invesco.[23] Against this order, Zee appealed to National Company Law Appellate

[18] *Supra* note 11.
[19] Press Release, *Disclosure under Regulation 30 of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended from time to time*, ZEE ENTERTAINMENT LTD. (Sept. 29, 2021), https://archives.nseindia.com/corporate/ZEEL_29092021190052_BSENSEREG30SEP29.pdf.
[20] Invesco Developing Market Fund & Ors. v. Zee Entertainment Enterprises Limited, CP - 322/2021.
[21] *Supra* note 14.
[22] Press Release, *Disclosure under Regulation 30 of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended from time to time*, ZEE ENTERTAINMENT LTD. (Oct. 2, 2021), https://archives.nseindia.com/corporate/ZEEL_02102021134528_BSENSE02102021.pdf.
[23] *Supra* note 20.

Tribunal ("**NCLAT**") on 6 October 2021,[24] wherein the NCLAT set aside the order of NCLT on the ground that Section 98 does not impose any time limit for the NCLT to pass an order, thus, Zee should be granted more time to file a reply.[25]

NCLAT observed that the 3-month time limit of Section 100(4) cannot be inserted in Section 98.[26] The relief that Invesco sought from the NCLT was to direct Zee to conduct EGM and this relief squarely falls under Section 98, not Section 100(4). Accordingly, NCLAT held that giving Zee less than 2 days to file a reply was against principles of natural justice, specifically, the principle of *audi alteram partem* and Rule 37 of NCLT Rules 2016[27] which provide that a reasonable and sufficient time is to be given to the parties for filing a reply. NCLT was thereby directed to grant further time to Zee for filing the said reply.

Thereafter, when the HC finally heard Zee's petition, its decision seems to have settled the law regarding shareholders' right to request an EGM, but at the same time, it has gathered some criticism as well. Invesco's first challenge was that the Court does not have jurisdiction to decide the dispute in light of Section 430 of the Act.[28] The Court set aside this challenge on the ground that the NCLT Rules lay down that the provisions over which NCLT/NCLAT don't have jurisdiction include Section 100, accordingly it was held that the Court had jurisdiction.[29]

A. INVESCO'S PRE-EMPTIVE ATTACK

Invesco's case was based on Section 100 of the Act, whereby it submitted that when the requirements given in Section 100 are fulfilled,

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[24] Zee Entertainment Enterprises Limited v. Invesco Developing Markets Fund & Ors., Company Appeal (AT) No. 121 of 2021.
[25] *Id.*
[26] *Id.*
[27] The National Company Law Tribunal Rules, 2016, Gazette of India, pt. II sec.3(i), Rule 37 (Jul. 22, 2016).
[28] Companies Act, No. 18 of 2013, §430 (Ind.).
[29] Zee Entertainment Enterprises Ltd. v. Invesco Developing Markets Fund and Others., SUIT (L) NO. 22522 OF 2021.

there can be no judicial interference with the requested EGM and the substance of the request letter i.e., proposed resolutions is immaterial for determining its validity.[30] On the point of procedural compliance, Invesco holds more than 10% of the paid-up share capital, has signed the request letter and delivered it to the registered office of the Zee, therefore the request letter is meeting the requirements of Section 100 and is thus, valid. Invesco harped on the fact that Section 100 uses the word "shall" rather than "may" with regard to the BoD's obligation to call the EGM upon a request from the shareholders which means that BoD has no option but to call the EGM upon the request letter.

Furthermore, it was argued that the validity of the request letter cannot be judged based on the proposed resolutions rather it has to be judged as per the requirements of Section 100.[31] It was rather argued that it is for the shareholders to decide this in the general meeting. If some proposed resolution is illegal, then it will simply not be passed by the shareholders in the meeting or if passed, will not be given effect but not calling the EGM in itself is a premature move. It was contended that Zee's suit is based on an assumption that the proposed resolutions will be passed by the required majority in the said EGM. However, when there is no certainty whether the proposed resolutions will be passed in the EGM, Zee's BoD cannot altogether refuse to call the EGM.

B. ZEE'S RESPONSE AGAINST INVESCO'S ATTACK

Zee's case was based on the argument that though the request letter's form complied with the requirements of Section 100, its substance i.e., the proposed resolutions was illegal due to which Zee was correct in refusing to call the requested EGM. Zee further contended that the shareholders' right to request for an EGM does not permit them to call an EGM for

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[30] LIC of India v. Escorts Ltd & Ors., (1986) 1 SCC 264 (Ind.).

[31] Cricket Club of India Ltd. & Ors. v. Madhav L Apte & Ors., (1974) SCC OnLine Bom 40 (Ind.).

something which is illegal and in contravention with various statutes and regulatory guidelines.

It was argued that the appointment of independent directors is governed by a tight statutory framework contained in the Companies Act, 2013 and SEBI LODR.[32] It is the Nomination and Remuneration Committee ("**NRC**"), which shortlists individuals from a data bank who are suitable to be appointed as independent directors.[33] NRC then, recommends these names to the BoD. No provision empowers shareholders to demand the appointment of specific individuals as independent directors.

Moreover, the request letter demanded the removal of the MD and CEO without proposing a replacement directly contravening Section 203 of the Act. Also, as per the MIB Guidelines, prior permission of MIB was to be taken before making any change in the BoD or CEO,[34] so removal of the CEO without prior permission of MIB which the request letter sought in the present instance, was invalid. The request letter also sought that the appointment of six independent directors shall be subject to the approval of MIB which is not in compliance with MIB Guidelines as it required "prior permission" of MIB and not "subject to approval". Thus, Zee contended that the request letter is invalid as it proposes entirely illegal resolutions.

In a nutshell, Invesco's defence of being procedurally compliant against Zee's argument of substantive infringement of mandates under the MIB guidelines, SEBI LODR, Takeover Code and Companies Act, 2013, should have created a tough tussle for the court to adjudicate. But, the Court found

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[32] Companies Act, No. 18 of 2013, §149(1), 149(4), 149(6), 149(10), 150, 152(2) & 178 (Ind.); *see also*, Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Gazette of India, pt. III sec. 4, Reg. 17 & 16(1)(b) (Dec. 22, 2015).

[33] *Id.*

[34] MIN. INFO. & BROADCASTING, POLICY GUIDELINES FOR UP LINKING OF TELEVISION CHANNELS FROM INDIA, Cl. 5.10, (2011).

no trouble in concurring with Zee on the illegality of the proposed resolutions and an analysis of the same is examined in the next section.[35]

III. DISSECTING THE COURT'S RATIONALE

A. NON-COMPLIANCE WITH SECTION 203 (1)

The Court observed that the proposed resolution for removal of MD and CEO without proposing a replacement would unequivocally make the Company non-compliant with Section 203(1) of the Act read with Rule 8 of Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 which requires a listed company to mandatorily have an "MD or CEO or manager and in their absence, a whole-time director; a Company Secretary; and a Chief Financial Officer".[36] The consequence of the removal of Mr. Goenka would be a penalty of fine on Zee as well as its directors, as is categorically mentioned in Section 203(5).

However, here the Court failed to consider that Section 203(4) sufficiently deals with a situation of vacancy of the office of the MD and CEO. As per the said sub-section, the BoD shall fill up such vacancy within six months from the date on which such vacancy arose. So, it is imperative to note that Section 203(5) cannot be read in isolation and must be read in light of Section 203(4) which gives a period of six months for filling up the vacancy of Mr. Goenka before attracting penalty for Zee and its directors.[37] Thus, calling the proposed resolution illegal for the removal of Mr. Goenka gives ample scope for challenge.

B. PROCEDURAL NON–COMPLIANCE BY CIRCUMVENTING NOMINATION AND REMUNERATION COMMITTEE

On this aspect, it was held that in light of the statutory regulations, there is no way in which the shareholders can demand the appointment of

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[35] Zee Entertainment Enterprises Ltd. v. Invesco Developing Markets Fund and Others., SUIT (L) NO. 22522 OF 2021.
[36] Companies Act, No. 18 of 2013, §203(1) (Ind.).
[37] A. RAMAIYA, GUIDE TO THE COMPANIES ACT (19th ed. 2020).

specifically named individuals as independent directors by bypassing the role of NRC.[38] With regard to independent directors, listed companies are mandated to have at least one-third of the total number of directors as independent directors as per Section 149(4).[39] It is pertinent to note that as per Section 149(6), "an independent director must be a person who, in the opinion of the BoD is a person of integrity and possesses relevant expertise and experience".[40]

Section 150 read with 152(2),[41] exhaustively specifies that independent directors are to be selected from a data bank of eligible individuals and shall be appointed with the approval of the shareholders in the general meeting. Additionally, an explanatory statement justifying the selection of the individual from the data bank for appointment shall be annexed to the notice calling such a meeting.[42] Section 150 also imposes a duty on the company to exercise all due diligence while selecting individuals from the data bank for being appointed as independent directors.

The NRC which all listed companies are required to constitute as per Section 178,[43] performs the duty of selecting individuals from the data bank for appointing independent directors and recommending these shortlisted names to the BoD. Then the BoD, after satisfying itself with the integrity, experience and expertise of the recommended individuals, forwards the names to the shareholders in the general meeting for their approval for appointment. Shareholders are empowered to only approve or disapprove the appointment of independent directors which is recommended to them by the BoD and NRC.

Keeping in mind that an independent director is an imperative pillar of corporate governance and performs a crucial role in keeping the

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[38] Zee Entertainment Enterprises Ltd. v. Invesco Developing Markets Fund and Others., SUIT (L) NO. 22522 OF 2021.
[39] Companies Act, No. 18 of 2013, §149(4) (Ind.).
[40] Companies Act, No. 18 of 2013, §149(6) (Ind.).
[41] Companies Act, No. 18 of 2013, §150 & 152(2) (Ind.).
[42] *Id.*
[43] Companies Act, No. 18 of 2013, §178 (Ind.).

company's corporate governance mechanism intact, the procedure of their appointment is strictly encapsulated in the provisions of the Act.[44] The shareholders cannot themselves nominate, appoint and approve the appointment of named individuals as independent directors.[45] This would in itself raise questions about the independence of such directors and invite the governance audits.[46]

However, the Court's observation that the role of NRC cannot be circumvented while appointing independent directors has attracted some criticism. An implied reading of SEBI LODR shows that the role of NRC comes into play only when director appointments are initiated by the BoD and not when the same is done by shareholder activists.[47] Therefore, in the present case, where the appointment of independent directors has been initiated by shareholders rather than BoD, the role of NRC can be sidestepped in light of SEBI LODR.[48]

Additionally, on this point, the Court failed to take note of Section 160(1) of the Act which explicitly recognizes the shareholders' power to propose candidates for being appointed as directors or independent directors.[49] A plain reading of the said provision along with its proviso tells us that a shareholder can, subject to the procedural requirements mentioned therein, propose the name of a person who is not a retiring director, for being appointed as a director or independent director. Upon receiving such proposal, Section 149(6) would come into play whereby the BoD would be required to satisfy itself with such candidate's integrity,

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[44] MINISTRY OF CORP. AFFAIRS, GOV'T OF IND., REPORT OF THE EXPERT COMMITTEE ON COMPANY LAW, 22-25 (2005), https://www.mca.gov.in/MinistryV2/management+and+board+governance.html.
[45] *Id.*
[46] Zee Entertainment Enterprises Ltd. v. Invesco Developing Markets Fund and Others., SUIT (L) NO. 22522 OF 2021.
[47] Umakanth Varottil, *Bombay High Court Order in Zee-Invesco Case: A Critical Analysis*, IND. CORP. L. (Oct. 27, 2021), https://indiacorplaw.in/2021/10/bombay-high-court-order-in-the-zee-invesco-case-a-critical-analysis.html.
[48] *Id.*
[49] Companies Act, No. 18 of 2013, §160(1) (Ind.).

expertise and experience for holding the office of independent director.[50] In light of the same, the Act does envisage circumvention of the role of NRC while appointing independent directors and the Court was wrong in saying that *"In the scheme of the Companies Act, shareholders do not get to choose individual independent directors."*[51] Nevertheless, there is a need for harmonization in the manner of appointment of independent directors prescribed under the SEBI LODR and the Act.

C. VIOLATION OF ARTICLES AND REGULATORY NORMS

The regulation and governance of listed companies are more stringent in comparison to other types of companies because of the public interest involved in the former. Due to this, listed companies such as Zee are subjected to another rigorous regulatory framework i.e., SEBI LODR in addition to provisions of the Companies Act. Regulation 17 of the SEBI LODR requires the BoD of a listed company to comprise "an optimum combination of executive and non-executive directors with at least half of the BoD being non-executive directors".[52] Furthermore, the Articles of Association ("**AoA**") contains the rules and regulations which govern the internal management of the company of which every shareholder is expected to have constructive notice.[53] Being an enforceable document between the company and its members, it binds the members under the obligation of the clauses.[54]

Zee's AoA mandates that the minimum number of directors of the company shall be 3 and a maximum number of directors shall be 12 unless otherwise decided in a general meeting.[55] The Court opined that since Mr. Goenka cannot be removed by virtue of Section 203(1), the total number

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[50] Companies Act, No. 18 of 2013, §149(6) (Ind.).
[51] Zee Entertainment Enterprises Ltd. v. Invesco Developing Markets Fund and Others., SUIT (L) NO. 22522 OF 2021.
[52] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Gazette of India, pt. III sec. 4, Reg. 17 (Dec. 22, 2015).
[53] S.S. Rajakumar v. Perfect Castings Private Ltd., (1968) 38 Comp Cas 187 (Ind.).
[54] Naresh Chandra Sanyal v. Calcutta Stock Exchange, 1971 AIR 422 (Ind.).
[55] *Supra* note 14.

of directors was 7 and the appointment of the 6 new independent directors as per the proposed resolutions would make the total number of directors 13, thus, contravening Zee's AoA. It was further held that if, as per the proposed resolutions, Mr. Goenka is removed and the 6 proposed independent directors are appointed then the BoD would consist of only independent directors (non-executive directors) which blatantly contravenes Regulation 17.

Apart from this, Regulation 16(1)(b)[56] is framed on the same lines as Section 149(6) of the Act with respect to the independent directors being persons having the required integrity, experience and expertise in the opinion of the BoD. Regulation 19 follows Section 178 of the Act requiring listed companies to constitute NRC for selecting individuals to recommend them for appointment as independent directors. A combined reading of these two statutes imposes a complex and comprehensive set of regulations on Zee with regard to the appointment of independent directors and composition of its BoD which the proposed resolutions were seeking to contravene.

D. ACQUISITION OF 'CONTROL' OVER ZEE

As per the SEBI (Acquisition of Shares and Takeover) Regulations 2011, the meaning of "control" includes when a person individually or along with persons acting in concert, by virtue of their shareholding rights, can exercise the right to appoint a majority of the directors.[57]Court expressed its agreement with Zee on the point that by appointing half of the BoD and removing the MD, Invesco was acquiring control over Zee for which it failed to make the mandatory public announcement of an open offer to be made to at least 26% of Zee's shareholders as per the

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[56] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Gazette of India, pt. III sec. 4, Reg. 16(1)(b) (Dec. 22, 2015).

[57] Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Gazette of India, pt. III sec. 4, Reg. 2(1)(e), (Sept. 23, 2011).

regulations.[58] Regulation 4 makes it mandatory for an acquirer to make such a public announcement of an open offer before directly or indirectly acquiring control over the target company.[59] Thus, the proposed resolutions attracted illegality due to their inconsistency with the takeover regulations.

Here, the Court erred because Invesco is appointing six independent directors which constitute only half of the directors, not the majority (more than 50%). Zee's BoD themselves acknowledged that Invesco was seeking to appoint 'half' of the directors.[60] In ***Arcelor Mittal India Private Limited v. Satish Kumar Gupta & Ors.***,[61] the Hon'ble Supreme Court held that it is when the acquirer has the power to appoint a majority of the directors, we can say he is in control of the company. Control means when an acquirer has the power to make the company do something i.e., positive right; not the power to stop the company from doing something i.e., negative right. Only when an acquirer is the prime driving force of the company, he can be said to be in control. Thus, in the present case, the Court erred in equating the term 'majority' and 'half'. In ***Sandip Save v. Chairman, SEBI***,[62] it was held that having positive rights like the right to appoint and remove directors of a company; the right to appoint some professionals to inspect the functioning of the company and other such rights would not be considered as 'control' provided that they are not permanent and would no longer remain if the associated shareholding is dropped.

Moreover, the appointments that Invesco is seeking are that of independent directors not Invesco's nominee directors, thus it cannot be said that Invesco would be able to exercise any control if these six

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[58] Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Gazette of India, pt. III sec. 4, Reg. 4 & 7, (Sept. 23, 2011).
[59] Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Gazette of India, pt. III sec. 4, Reg. 4, (Sept. 23, 2011).
[60] *Supra* note 14.
[61] Arcelor Mittal India Private Limited v. Satish Kumar Gupta (2019) 2 SCC 1 (Ind.).
[62] Sandip Save v. Chairman, SEBI (2003) 41 SCL 47 SAT (Ind.).

independent directors are appointed.[63] An Independent director by its definition is not a nominee director.[64] It is important to note that in the definition of "control", SEBI is in the process of changing the "right to appoint a majority of directors" to "right to appoint a majority of non-independent directors".[65] This move by SEBI shows that appointing a majority of independent directors does not amount to acquiring control over the company.

E. SECTORIAL CHECK OVER THE DIRECTORS' APPOINTMENT

Lastly, the Court observed that the proposed resolution seeking removal of Mr. Goenka without mentioning anything about taking prior approval of MIB was in direct contravention with the MIB guidelines which categorically mandated prior permission to be taken from MIB before making any change in the CEO or BoD.[66] In the same way, when MIB guidelines specify 'prior permission' of MIB, there was no way in which six independent directors could be appointed 'subject to approval' of MIB as per the request letter. For these reasons, it was held that the proposed resolutions for the removal of the CEO and appointment of six independent directors were illegal as per MIB guidelines. Giving effect to these proposed resolutions would lead to the penalization of Zee in terms of suspension of its license and an outright ban on broadcasting for 30 days.[67]

The rationale is imperfect in two aspects. *First,* the application for taking prior approval from MIB was to be made by Zee who is the license holder,

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[63] Rajat Sethi & Sarangan Rajeshkumar, *Requisitioning A Shareholders' Meeting: The Unfolding Events Relating to Zee Entertainment and Dish TV*, S&R ASS. (26 Oct. 2021), https://www.snrlaw.in/requisitioning-a-shareholders-meeting/.
[64] Companies Act, No. 18 of 2013, §149(6) (Ind.).
[65] SEBI, GOV'T OF IND., BRIGHT LINE TESTS FOR ACQUISITION OF 'CONTROL' UNDER SEBI TAKEOVER REGULATIONS 8 (Discussion Paper, 2016); *see also*, Anurag Gupta & Sushma Reddy, *SEBI's Brightline Test: The Right Way to Move Forward?* 2.2 JCLG 50 (2017).
[66] *Supra* note 35.
[67] MIN. INFO. & BROADCASTING, POLICY GUIDELINES FOR UP LINKING OF TELEVISION CHANNELS FROM INDIA, Cl. 8.2.1, (2011).

not the shareholders.[68] Zee could have certainly filed the application to MIB for its prior approval before the EGM was conducted. It is to be noted here that in the request letter, Invesco did request Zee to take the prior approval from MIB as soon as possible.[69] *Secondly,* MIB guidelines do not specify exactly when this application for prior approval has to be made to the MIB.[70] Whether the prior approval has to be taken before the NRC recommends names to BoD for an appointment or before the BoD put the shortlisted names before the shareholders or before the shareholders finally approve the appointment in the general meeting or before the appointed directors take office. There are multiple stages in the process of appointment of directors and at what stage is the MIB prior approval to be taken is unclear.[71] Therefore, declaring the proposed resolutions illegal on the ground of non-compliance with MIB guidelines leaves room for challenge.

IV. COMMON LAW VIS-A-VIS INDIAN JURISPRUDENCE OF VALIDITY OF EGM REQUISITION

There is a stark contrast in the approach adopted by foreign judiciary and Indian judiciary while judging the validity of a requisition for EGM. Surprisingly, the HC decided to stand in favour of the foreign courts' view rather than that of the Indian courts which makes it all the more necessary to understand the difference and similarities between them.

A. COMMON-LAW VIEW

The question which had come before the HC in the Zee-Invesco dispute was not at all new for the foreign courts. This question had arisen way back in 1884 in ***Isle of Wight Railway Co v. Tahourdin***,[72] wherein it

[68] *Supra* note 67.

[69] *Supra* note 11.

[70] S. Vivek, *Zee-Invesco: An Analysis of the Bombay High Court Judgment*, THE NLS BLOG (Nov. 10, 2021), https://www.nls.ac.in/blog/zee-invesco-an-analysis-of-the-bombay-high-court-judgment/.

[71] *Id.*

[72] Isle of Wight Ry. Co v. Tahourdin [1884] 25 Ch D 320 (CA).

was observed that shareholders' right to requisition for an EGM is imperative because that is the only way in which they can set things right if the directors are doing something against the interests of the company, thus they should not be barred from exercising this right. However, it was also held that if the purpose of calling the requested EGM or the proposed resolutions cannot legally be given effect to or are completely contrary to law, then the BoD is justified to refuse to call the meeting. In such a case, the Court could grant an injunction to bar the shareholders from conducting the meeting.

The same view was taken by the Court in the case ***Fruit and Vegetable Growers Association v. Kekewich***.[73] Subsequently, even in ***Queensland Press Ltd v. Academy Investments No 3 Pty Ltd &Anr***.,[74] and ***Rose v. McGivern &Ors.***,[75] shareholders had requested the BoD for an EGM which was refused due to the illegality of the resolutions proposed to be voted for in the meeting. Here again, the Courts followed the decision in ***Isle of Wight Railway Co v. Tahourdin*** and held that the BoD could not be compelled to call the EGM if the resolutions proposed for such meeting will be legally ineffective if passed. It was observed that since the proposed resolutions could not even be lawfully implemented if passed at the meeting, there was no point in calling the meeting. This proposition has also been favoured in ***Turner v. Berner***[76] and ***NRMA v. Parker***.[77]

It is pertinent to note Section 303(5) of the Companies Act, 2006 of the United Kingdom which provides that "when shareholders request the BoD to call an EGM, the former can propose only those resolutions in the requested meeting which, if passed, would not be ineffective due to contravention with any statute or the company's constitution or

[73] Fruit and Vegetable Growers Ass'n v. Kekewich [1912] 2 Ch. 52.
[74] Queensland Press Ltd. v. Acad. Inv. No 3 Pty Ltd & Anr. [1987] QC 3.
[75] Rose v. McGivern & Ors. [1998] 2 BCLC 593 (Ch D).
[76] Turner v. Berner [1978] 1 NSW LR 66 (Austl.).
[77] NRMA v. Parker [1986] 11 ACLR 1 (Austl.).

otherwise".[78] This provision is in line with the foreign judgements mentioned above and, in the Zee-Invesco dispute, HC found no reason to deviate from this well-established principle merely because it is not mentioned in the Indian Companies Act.

In ***Kaye & Anr v. Oxford House (Wimbledon) Management & Ors.***,[79] the Court pointed out the importance of Section 303(5) for protecting the company from such shareholders who attempt to call meetings proposing resolutions to make the company do something contrary to law. It was held that the responsibility is cast on the BoD to evaluate the proposed resolutions before calling the requested meeting. As per this provision, BoD ought to call the meeting unless the resolutions cannot be given effect due to their illegality. In case the shareholders move the Court against the BoD's refusal to call the requested meeting, the Court would not be constrained to consider the BoD's reasons for refusal, rather, the Court would have to evaluate the legality of the proposed resolutions.

B. INDIAN VIEW

Indian judiciary has shown a mixed approach towards this proposition. In ***Cricket Club of India Ltd. & Ors v. Madhav L Apte & Ors.***,[80] a company had received a requisition from its members to call an EGM proposing a resolution which was refused because such resolution was contrary to a provision of the Companies Act, 1956 and could not be given effect to, even though the requisition was in line with the requirements of Section 169 (Section 100 of Companies Act, 2013). When this dispute came before the Bombay High Court, it was held that if the requisition for EGM meets the requirements laid down in Section 169, the BoD will have no choice but the call the EGM even if the proposed resolution is contravening some provisions of the Act. It was observed that neither the BoD nor the

[78] Companies Act 2006, c.3, § 303(5) (Eng.).

[79] Kaye & Anr. v. Oxford House (Wimbledon) Mgmt. & Ors. [2019] EWHC 2181 (Ch).; *see also*, Bell Resources Ltd v. Turnbridge Pty Ltd., [1988] 13 A.C.L.R. 429; *see also*, Smith v. Paringa Mines Ltd., [1906] 2 Ch. 193.

[80] Cricket Club of India v. Madhav L Apte (1974) SCC OnLine Bom 40 (Ind.).

Court can sit to check the legality of the proposed resolutions if the requisition fulfils the requirements of Section 169.

Many legal scholars including A. Ramaiya did not see eye to eye with the HC on this proposition.[81] However, in ***LIC of India v. Escorts Ltd & Ors.***,[82] the apex court showed a similar line of thought and held that shareholders' right to demand the BoD to call an EGM cannot be curbed if the requisition is meeting the requirements of Section 169.Court emphasized that while exercising this right, shareholders are neither required to give reasons for the resolutions which they propose nor can the Judiciary interfere to review the reasons for the proposed resolutions.[83] The question of the legality of the proposed resolutions was not taken up by the Supreme Court.

Be that as it may, the Court cited one instance when the HC had shown concurrence with ***Isle of Wight Railway Co v. Tahourdin*** instead of ***Cricket Club of India Ltd & Ors v. Madhav L Apte & Ors***. In ***Centron Industrial Alliance Ltd. v. Pravin Kantilal Vakil & Anr.***,[84] the BoD did call an EGM as per a requisition made by the shareholders proposing a resolution that could be effectuated legally. However, some other shareholders sought an injunction against such EGM. The proposed resolution was to withdraw a company petition filed for sanctioning a scheme of amalgamation and to re-work the terms of the scheme for the benefit of the company.

Here, the Court distinguished *irregular* resolutions and those which are *illegal*. It was held that the BoD ought to call a requisitioned EGM when the proposed resolutions can be legally implemented and the *irregularity* of the

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[81]A. RAMAIYA, GUIDE TO THE COMPANIES ACT (19th ed. 2020); *see also*, CR DATTA, COMPANY LAW (7th ed. 2016); *see also*, JEHANGIR. M.J. SETHNA, 2 INDIAN COMPANY LAW, 2364 (25th ed. 2020).
[82] LIC of India v. Escorts Ltd. & Ors. (1986) 1 SCC 264 (Ind.).
[83] *Id.*
[84] Centron Industrial Alliance Ltd. v. Pravin Kantilal Vakil & Anr. (1982) SCC OnLine Bom 318 (Ind.).

form in which the proposed resolution is made is immaterial because eventually, it will be legal to implement the resolution if passed at the meeting.[85] The Court observed that if there is no doubt that the resolutions are illegal, then it is futile to call a requisitioned EGM.[86] If the proposed resolutions are good in law, then even if the BoD considers them to be unwanted or not in its favour or not in the best interest of the company, it is still bound to call the requisitioned meeting.[87] Such proposed resolutions being irregular not illegal can be legally implemented and thus, the BoD cannot refuse to call the requisitioned meeting.

Subsequently, in ***B.Sivaraman v. Egmore Benefit Society Limited*,**[88] the shareholders who did not get elected as directors had made the requisition for an EGM to remove the properly elected directors. The Madras High Court decided that merely because the requisition for EGM meets the requirements of Section 169 does not mean the BoD are obliged to call the EGM for the removal of recently elected directors.[89]

Therefore, moving forward, the courts are bound to face a dilemma of appreciating the common law view while adjudicating such disputes between shareholders of Indian companies and their BoD. It is to be seen if courts will hold the Bombay High Court's present reasoning in precedential regard, given the criticisms surrounding the decision.

V. INVESCO'S HECKLE RAISING DECIBELS ON SHAREHOLDER ACTIVISM

A. RELATIONSHIP BETWEEN THE INSTITUTIONAL SHAREHOLDING AND SHAREHOLDER ACTIVISM

Although Foreign Institutional Investors ("**FII**") like Invesco hold substantial shares in Indian companies, they have seldom exercised voting

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[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] B. Sivaraman v. Egmore Benefit Society Limited (1992) 75 Com Cases 198 (Mad).
[89] *Id.*

rights in those companies, barring exceptional circumstances.[90] The rise of large institutional shareholders in the corporate world makes it possible for the large institutional shareholders to control enough shares to overcome the separation of ownership and control in large public companies and have an influence on their management through the exercise of managerial powers in the general meetings despite plummeting share prices.

FII or any other institutional investor's natural drive is towards using 'exit' instead of 'voice' when they are not entirely happy with corporate performance.[91] When compared to the UK corporate governance model, Myners Report (2000) suggests that the shareholder 'exit' is an unattractive choice due to the lower offer price founded on unstable market confidence from the other investors and market sentiment. In the case of Invesco which holds a significant stake in Zee, exit is not a viable option given the market instability.[92] These factors should drive investors to use their 'voice' where issues of their concern arise which Invesco has ideally subscribed to through its requisition and negotiations with management.[93] In most aggressive cases shareholders choose to use the threat of exit as a mechanism to influence managerial decisions.[94]

Shareholders may also resort to aggressive and confrontational manner to 'co-manage'; however, it is proven that such a step does not lead to any

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[90] Chiranjivni Chakraborty, *Has the Indian stock market finally found a cure for its FII complex?,* ET MARKETS, (Dec 20, 2021), https://economictimes.indiatimes.com/markets/stocks/news/has-the-indian-stock-market-finally-found-a-cure-for-its-fii-complex/articleshow/88383411.cm.

[91] Iragavarapu Sridhar*, Corporate Governance and Shareholder Activism in India—Theoretical Perspective*, 6 THEORETICAL ECON. LETTERS 731 -741 (2016), http://dx.doi.org/10.4236/tel.2016.64077.

[92] Bernard Black, *Shareholder Passivity Re-examined*, 89 MICH. L. REV. 520, 534 (1990), https://repository.law.umich.edu/mlr/vol89/iss3/4.

[93] Terry McNulty & Donald Nordberg, *Ownership, Activism and Engagement: Institutional Investors as Active Owners*, 24 CORP. GOV.: INT'L REV. 346– 358. (2016) at https://doi.org/10.1111/corg.12143.

[94] Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22(7) REV. FIN. STUDIES. 2645–2685 (2009), https://doi.org/10.1093/rfs/hhp037.

interest's fulfilment in a long run.[95] Further, the shareholders have restricted rights provided for amending the AoA of a company and/or such other internal processes.[96] This defeats the concept of co-managing and the very purpose of having re-appointment and eventually making the BoD a self-perpetuating body.[97] It is coupled with challenges that the campaigning costs the activist, while benefits end up being reaped by other shareholders creating a dilemma of the collective action.[98] A combative strategy should be present for shareholder activism and in the dispersed and one-sided activism of Zee – Invesco case it is not possible for the collective action to reap benefits for all but does only for some. However, Invesco didn't suggest or evaluate this strategy while tabling the requisition to Zee's BoD.

Currently, this wave of aggressive approaches is the influence of the US corporate structures with an increase in the FIIs portfolios and shift from the promoter based to public intensive boardrooms. According to the OECD report, India now represents an estimated investment of close to USD 400 billion in the public equity market, which is around 30% of total market capitalization in India and has institutional equity holders of 34% of the total market capitalization.[99] Further, when analysed with the ICDR Regulation 16, SEBI has actively discouraged the promoter stake in the post-listing lock-in period for private equity and venture capital firms allowing them to sell 20% of their shares within 18 months after listing,

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95 Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance,* 63 J. FIN, at 1729-1775 (2008), https://doi.org/10.1111/j.1540-6261.2008.01373.x.

96 Yizhi Jasmine Li, *The Impact of Shareholder Activism on Firm's Performance*, (EBIMCS 2020: Proceedings of the 2020 3rd International Conference on E-Business, Information Management and Computer Science, 2020), https://doi.org/10.1145/3453187.3453313.

97 *Supra* note 91.

98 Umakanth Varottil, *Shareholder activism is growing in India. But it faces some hurdles*, IND. EXPRESS (Nov. 21, 2021), https://indianexpress.com/article/opinion/columns/shareholder-activism-is-growing-in-india-but-it-faces-some-hurdles-7601033/.

99 OECD, *OWNERSHIP STRUCTURE OF LISTED COMPANIES IN INDIA*, 4 (2020), www.oecd.org/corporate/ownership-structure-listed-companies-india.pdf.

instead of three years period.[100] There is a logical agreement with the proposed plans of Invesco to reduce Zee's promoter shareholders to cope with the upcoming regulation and market activity.[101]

B. Can Borderline Aggressive Activism be an answer?

In the Invesco case of the decision-making process within a corporate structure, the two sides of the company and management are divided. The divide will deepen and will demand certain conduct and direction that the company will have to ensure and endure the outcomes of the divide for a while. Usually, the divide is caused by the prominent shift of objectives and structure of the company which might lead to the shedding off of privileges of one side.[102] However, it is difficult in the event when the shareholders are uncertain. Invesco's requisition and the procedural issues concerning approaching the NCLT bench are a mark of an aggressive strategy. The shareholders in such instances assert their power as owners by shaking the sentiment of the market in an unfavourable manner to the company or causing interventions in the indoor management of the company, causing a constant flux of activism movement.[103]

Aggressive activism is a rare case in a jurisdiction of India, wherein in the context of the UK, it is a deliberate move of the shareholders to exploit an opportunity over a divide for share price gains.[104] There is a systematic effort on the end of dispersed and institutionalized shareholders cooped up

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[100] SEBI, *Review of Regulatory Framework for Promoter, Promoter Group and Group Companies* (July 29, 2021), https://www.sebi.gov.in/sebi_data/meetingfiles/aug-2021/1628663782833_1.pdf.

[101] Tanya Thomas, *Subhash Chandra to sell 16.5% stake in Zee,* Live Mint (Nov. 21, 2019), https://www.livemint.com/companies/news/subhash-chandra-to-sell-another-16-5-stake-in-zee-to-retain-only-5-11574256124366.html.

[102] Ami Galani & Nathan Rehn, *Related Party Transactions; Empowering Boards and Minority Shareholders to Prevent Abuses* 22(2) Nat'l Law School India Rev. 31, 36 (2010).

[103] Peter Watts, *Company Contracts and Reckless Trading: Re Global Print Strategies Ltd.*, 15 NZ. Buss, L. Qtly. 3 (2009).

[104] John Armour & Brian R. Cheffins, The Rise and Fall (?) of Shareholder Activism by Hedge Funds (Eur. Corp. Governance Inst., Working Paper, 2009), http://dx.doi.org/10.2139/ssrn.1489336.

in requisition and aggressive activism. Such investors have to place reliance on informal and consistent engagement which eventually is publicized form of aggression. It leaves no option for the investors to either – voice their concerns or exit. This results in a proxy battle between management and shareholders as to which director should be nominated to the board.[105]

However, instead of internal resolutions of proxy war, Invesco proceeded with a public suit against the company and its management, with an assumed aim of mobilizing other shareholders to takeover. While analysing the two options Invesco did have a considerable share of 17.8 % and a departure from the same would have been effective in theory but not in practice. It is due to the very public proxy war that posts the merger prospects insight the ownership changes lifted Zee's stock almost 70% since Sept. 9 which was estimated to close the 24% gap with the price implied by the Sony deal.[106] Later the stock ended 4.3% higher after the court injunction came as a setback for Invesco. But it fell as much as 3.5% in early trade the very next day. The view behind these changes is that where share prices do not dramatically increase as a result of shareholder activism it is because of the defensive shareholder and the outcome is to safeguard one's investment in the company without being prepared to sell. Thus, when the stock market is informed that the directors of a company are not acting in the best interests of the shareholders, the price of the company's shares will fall and it will be taken over by new owners who will install new directors to run the business more efficiently.[107]

It is arguable that, where 'aggressive' activists are trying to interfere with management, they have stepped beyond the boundaries of 'own power' into the area of the general power of management. However, if an Invesco purports to act in a 'co-managing' capacity to influence directorial actions,

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[105] ANITA ANAND, SHAREHOLDER-DRIVEN CORPORATE GOVERNANCE, 346 (Oxford University Press, 2020).
[106] Una Gulati, *Activist Improves Clumsy Plat in Indian TV Drama,* REUTERS (Oct. 12, 2021), https://www.reuters.com/breakingviews/activist-improves-clumsy-plot-indian-tv-drama-2021-10-12/.
[107] *Supra* note 91.

then accountability could similarly be attracted.[108] The Bombay HC judgment recognised that lest that accountability of co-managing is in place, the non-appointed persons would be able to intervene in management with a greater degree of freedom than appointed management, and this would be against the spirit of the law. Therefore, the mandatory and regular occurrence of an AGM assumes great significance.

The Act provides various mechanisms that while most of these transactions can be undertaken in EGM's also, members who may want to raise such issues may not be able to ask for convening the meeting due to the strict requirement of the number of members needed to convene an EGM as specified in Rules 17 of the Companies (Management and Administration) Rules 2014.[109] Had Invesco been able to procedurally satisfy its demand under the Company Rule, it could have achieved an example of activism that India requires.

VI. RECOMMENDATIONS AND CONCLUSIONS

Though the Zee-Invesco dispute will certainly continue by way of appeals, for now, the Bombay High Court's decision does seem to have settled the law governing shareholders' right to call an EGM whereby shareholders will only succeed in calling an EGM if the resolutions proposed can be legally effectuated apart from complying with the procedural requirements of Section 100. The decision seems to suggest an amendment to Section 100 by incorporating something similar to Section 303(5) of the UK Companies Act. This may seem plausible on some levels but at the same time, it is looked down upon by the shareholders whose pivotal right is strangulated. In the authors' opinion, it is no doubt correct to stop shareholders from making the company do something illegal but at the same time the right to requisition for an EGM is an integral feature of corporate governance since it is the only way in which shareholders can

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[108] *Id.*

[109] Companies (Management and Administration) Rules 2014, Gazette of India, pt. II, sec 3(i), Rule 17 (March 27, 2014).

step in to set things right in the company if the BoD are doing something wrong. It may not be always correct to stop shareholders from exercising this right on the ground of technicalities. After a critical reading of the decision, it is evident that all of Invesco's proposed resolutions were not entirely illegal but rather merely required some conditions to be fulfilled. There is a need to harmoniously interpret rather than create a binary in disputes and not view it as compliance for the companies to fulfil.

On the note of the aggressive activism undertaken by Invesco, it is plausible to see Invesco's activism as an example of the willingness and power of the shareholder of the company to take on the BoD on a simple issue of appointment and removal of the directors of a company. But it is a step shy from being flawless in its procedure. With the backing of complicated regulatory and sectorial guidelines, Zee had a valid and justified claim to subdue the voices of the shareholders. However, this instance is not a step backwards in activism but rather a manifestation of the change in the governance among the shareholders of the company. Further, the relation between FII and activism in India is a structural pattern change that can be evidenced in the UK, US corporations' instances when they undertook to overhaul the governance framework. SEBI and the Ministry of Corporate Affairs as regulators have been trying to bring a little more inclusivity to the FIIs through the BRSR framework, ESG Disclosures, etc., and giving companies a little run for their money. With multiple instances sprouting up and no decrease in the questions, resolutions and demands being put forth by the shareholders, Zee – Invesco dispute can be termed as a positive interaction and engagement which empowers other such investors.

BRIDGING THE GAP BETWEEN SEBI'S INVESTIGATION PROCEDURE AND PRINCIPLES OF NATURAL JUSTICE - IDENTIFYING THE LOOPHOLE IN THE LAW

Arushi Bhagotra & Rounak Doshi[*]

ABSTRACT

*This article focuses on the importance of the supply of documents, relied upon by the Securities and Exchange Board of India ("**SEBI**") during its investigation(s) to the aggrieved party. The basic aim of the article is to highlight the drawbacks which exist in the investigative procedure of the SEBI and also discuss the arbitrary implementation of the investigative power that SEBI enjoys. The basic premise of the article is based on the established practice of the Indian Courts that the aggrieved party is not entitled to receive any information about or the documents themselves that the SEBI authorities collect, however not rely upon, while investigating any case under the SEBI Act and its related legislations. In this regard, the article deliberates upon the relevance of the already existing obligations of the SEBI as per the SEBI Act, the Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 and the Securities Contracts (Regulation) (Procedure for Holding Inquiry and Imposing Penalties) Rules, 2005, among others, concerning the supply of documents to the aggrieved person. While looking at the Principles of Natural Justice as well as similar procedures followed by other Common Law countries, namely the United Kingdom and the United States, the authors have come to the conclusion that the Indian system is not only against the Principles of Natural Justice, but also against the general international practice adopted by India's sister nations. Hence, it is essential that the Indian authorities take steps to mould the law as per Principles of Natural Justice and contemporary practice across the globe.*

Keywords: SEBI, Investigation, Documents, Show-Cause Notice and Principles of Natural Justice.

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I. INTRODUCTION

Securities and Exchange Board of India ("**SEBI**") is a statutory body that regulates the capital and securities market in India. SEBI has been provided with various legislative, executive and judicial powers to manage the securities market.[1] Along with making the regulations and monitoring the market, SEBI also has the authority to conduct investigations and enquiries if there is violation of various rules and regulations created by it for protecting the interest of the investors of the securities market.[2]

While conducting these above-mentioned investigations, SEBI is generally required to fulfil multiple procedural obligations,[3] one of which is to send a show-cause notice to the party being investigated before taking any actions against it.[4] Whenever SEBI conducts an investigation, it collects several documents to conduct a comprehensive analysis. Thereafter, on the basis of the observations made, a show-cause notice is sent to the investigated party. Such show cause must be accompanied with the reasons and proofs for conducting such investigation.[5] This is usually done in

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[1]The Securities and Exchange Board of India Act, No. 15 of 1992, Preamble (Ind.) [hereinafter SEBI Act].
[2] SEBI Act, *Id.*
[3] SEBI Act, *Id.*
[4] Securities Contracts (Regulation) (Procedure for Holding Inquiry and Imposing Penalties) Rules, 2005, Gazette of India, pt. II sec. 3 sub-sec. (i), Rule 4(1) (Apr. 11, 2005). [hereinafter SCR Inquiry Rules].
[5] *Id.*

furtherance of the principles of natural justice as enshrined in the Constitution of India, which is the Supreme Law of the land.[6]

There lies a grey area in the law when the question of the supply of supporting documents and proofs comes into the picture. The same is because the obligation entailed by the law is open to interpretation due to its vagueness, and has not prescribed any limitations on SEBI's power to carry out the investigation. There have been several instances where the claim of supply of only documents that have been relied upon and referred to by one party, i.e., SEBI, has been opposed with the counter-claim of supply of all the documents collected during the investigation, irrespective of its relevancy, by the other party, i.e., the party under investigation.[7] This counter-claim is generally made with the contention being that supply of all the documents which are collected by SEBI during its investigation would facilitate the investigated party in making an elaborated and rightful defence against the accusations made against it, and this would further the ends of justice by adhering to the requirements of principles of natural justice. For example, if SEBI collects around 1000 documents while conducting its investigation and merely relies upon 100 of them in its show cause notice to the investigated party, it would be appropriate to conclude that there would be a high probability that at least a few documents in these 900 documents might support the cause of the investigated party. This would help in fulfilling the requirement of providing an equal and complete opportunity to both the parties to the case.

Therefore, it is critical to analyse the stance taken by the judicial authorities on this question of procedure. It should be noted that the same has been contradictory on multiple occasions, which stimulates a need to establish a concrete position through statutory provisions or judicial

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[6] Anuradha Bhasin v. Union of India, AIR 2020 SC 1308.
[7] Shruti Vora v. SEBI, Misc. Application No.347 of 2020 and Appeal No. 309 of 2020, SAT (Mar. 22, 2021) (India) [hereinafter Shruti Vora]; Price Waterhouse v. SEBI, [2011] 108 SCL 216 (SAT); Natwar Singh v. Director of Enforcement, (2010) 13 SCC 255 (Ind.).

pronouncements. This triggered the authors to delve deep into this question of law and determine what could be the right stance taking into account the position of law in developed jurisdictions like the USA and UK, along with various established writers of securities and Indian law.

This research study has been divided into two parts, i.e., Part I dealing with the current obligation which is entailed upon the SEBI, along with the principles of natural justice and their application upon SEBI's investigative procedure. Thereafter, Part II of the study includes the stance of the Indian Judiciary and various foreign jurisdictions on the procedure dealing with investigations. These foreign jurisdictions will majorly include the US and UK, from where the norms of Indian security laws and regulations have been majorly adopted.

To conclude, the authors will conduct a comprehensive analysis of the obligations entailed by the principles of natural justice, and the application of the stance of international jurisdictions on the Indian authorities while putting forth their perspective with respect to the question of supply of 'only relied upon or referred to documents' or 'all the documents collected during the investigation'. In the subsequent section, the authors have provided a detailed account of the current obligations of the SEBI while dealing with investigative procedures as provided under the various associated legislations and judicial precedents.

II. PART I: CURRENT OBLIGATION OF SEBI AND PRINCIPLES OF NATURAL JUSTICE

A. WHAT IS THE CURRENT OBLIGATION?

Before delving into the details of what obligations should be entailed upon the SEBI in relation to the supply of documents to the investigated party, we must understand the nuances of the already established obligation. In order to determine the current statutory obligations which, the SEBI has to meet, a detailed look into the SEBI Act along with its subsidiary acts is imperative. In relation to investigations or inquiries conducted for alleged violations of the SEBI Act, the SEBI Act does not provide any specific

procedure in detail; apart from section 11C,[8] i.e., Investigation, and section 15I,[9] i.e., Power to Adjudicate, no other provision even mentions the procedural requirement for any investigation or inquiries. Since the procedural requirements mentioned in Sections 11C and 15I are also very few and inconclusive, therefore, a reference must be made to the subsidiary acts of the SEBI.

There are multiple subsidiary acts, such as the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003,[10] ("**FUTP Regulations**") and the Securities Contracts (Regulation) (Procedure for Holding Inquiry and Imposing Penalties) Rules, 2005,[11] which discuss the violations provided in the SEBI Act in detail, and therefore, also layout specific detailed procedure for inquiry or investigation for such violations.

While going through the regulations such as FUTP Regulations[12] or SEBI (Prohibition of Insider Trading) Regulations,[13] it can be observed that apart from listing the basic procedure under these regulations, reference has been made to The Securities Contracts (Regulation) (Procedure for Holding Inquiry and Imposing Penalties) Rules, 2005 ("**The SCR Inquiry Rules**"),[14] wherein a detailed step by step process has been prescribed, and therefore, its compliance has been made mandatory for the fair completion of any inquiry or investigation under the SEBI Act.

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[8] SEBI Act, § 11C, *supra* note 1.
[9] SEBI Act, § 15I, *supra* note 1.
[10] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003, Gazette of India, pt. II sec. 3 sub-sec. ii (July 17, 2003). [hereinafter FUTP Regulations].
[11] SCR Inquiry Rules, *supra* note 4.
[12] FUTP Regulations, Reg. 12, *supra* note 10.
[13] The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Gazette of India, pt. III sec. 4, (Jan. 15, 2015).
[14] SCR Inquiry Rules, Rule 4, *supra* note 4.

Under The Securities Contracts (Regulation) (Procedure for Holding Inquiry and Imposing Penalties) Rules, 2005, specific procedural requirements have been provided. However, there is no explicit mention of any obligation upon the SEBI for the supply of documents collected during an investigation or inquiry. Nevertheless, similar to the SEBI Inquiry Rules, the SCR Inquiry Rules do give the board or adjudicating officer the ability to gather evidence, issue summons for presence, and order the production of documents when conducting an investigation.[15] Even the SEBI Inquiry Rules and the SCR Inquiry Rules, order the rendering of documents when conducting an investigation.[16]For the purposes of determining the current status, it is pertinent to refer to the Securities Appellate Tribunal ("**SAT**") judgement in the matter of ***Shruti Vora v. SEBI***,[17] wherein the Tribunal was dealing with the question if a 'forwarded as received' WhatsApp message regarding the financial information of a company, shortly after the in-house finalization of the financial results, could be considered as UPSI under the provisions of the SEBI. Herein, questions were raised over the documents which were supplied by the SEBI to the investigated party. Multiple requests were made by the investigated party that several other documents which were collected by the SEBI but not supplied to the investigated party be made available to the party to further the ends of justice. It was held by the SAT that although Rule 4[18] of the Rules[19]does not provide any specific provision for the supply of copies of any documents, the concept of fairness and principles of natural justice are in-built in Rule 4. Therefore, there is a requirement to supply the documents relied upon while serving the show cause notice.[20] The court had considered it essential for the person to file an efficacious reply in its defence.[21]

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[15] *Id.*

[16] Depositories (Procedure for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules, 2005, Securities and Exchange Board of India, § 4 (Apr. 11, 2005).

[17] Shruti Vora, *supra* note 7.

[18] *Supra* note 14.

[19] *Id.*

[20] *Id.* at § 4(1).

[21] Shruti Vora, *supra* note 7.

This was the take of the SAT concerning the statutory obligation for the supply of documents. However, it has to be considered that the take of the SEBI and SAT has been flexible and deviates on a case-to-case basis. The importance of the principles of natural justice in ensuring the maintenance of transparency by authorities has been upheld in numerous cases. These principles are the core of the Indian Constitution and are necessary for ensuring that neither party is given an undue advantage over the other in any proceedings.

Further, considering that even in the matter of ***Shruti Vora v. SEBI***,[22] the SAT interpreted the rules in the manner to obligate SEBI to supply the relied upon documents by the application of principles of natural justice. Therefore, understanding these principles is very essential in order to determine the significance of them in SEBI's investigative obligations and Indian court proceedings.

B. THE PRINCIPLES OF NATURAL JUSTICE AND ITS SIGNIFICANCE IN SEBI'S INVESTIGATIVE OBLIGATIONS

Natural Justice is a principle that requires the implementation of justice in line with one's conscience.[23] It alludes to the inherent judicial procedural rules, and fairness in conduct. In India, the Supreme Court in ***Canara Bank v. V. K. Awasthi,***[24] has asserted that principles of natural justice are regulations defined by courts as the minimum protection of an individual's privileges against arbitrary methodologies that may be used by a judicial, quasi-judicial, or administrative authority when making an order impacting those privileges.[25]

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[22] *Id.*
[23] Justice Brijesh Kumar, *Principles of Natural Justice*, 3 J.T.R.I. J. (1995).
[24] Canara Bank v. V. K. Awasthi, (2005) 6 SCC 321 (Ind.).
[25] *Id.*

In addition to the preamble to the Constitution of India, Article 14 is the most significant embodiment of the principles of natural justice as it assures Indian citizens equality before the law and equal protection under the law.[26] Article 14 goes to the core of arbitrariness, and it has been employed by the Supreme Court to support the view that natural justice is an indispensable feature of the administrative system.[27] In ***Maneka Gandhi v. Union of India***,[28] the Supreme Court held that Article 14 is an authority for the premise that natural justice principles are an intrinsic aspect of the guarantee of equality conferred by Article 14.Thus, an order robbing an individual of his civil right passed without supplying him with an opportunity to be heard tends to violate the principles of natural justice. While keeping the principles of natural justice in mind, in the past, the SEBI has opined that natural justice requirements are fulfilled once the relied upon documents are supplied.[29]

To understand the stance taken by the Indian Judiciary while deciding on matters related to SEBI's obligations concerning the furnishing of documents, the authors have expanded on the judiciary's existing decisions in the subsequent section.

III. PART II: JUDICIAL TRENDS

A. INDIAN PERSPECTIVE:

The concern of supply of not relied upon documents is a disputed question according to the authors, however, the Indian Judiciary has established an inconclusive stance concerning SEBI's obligation with respect to the supply of documents. There are certain landmark judgements wherein the issue of supply of documents was discussed in detail, for instance, in the matter of ***K.C. Tandon v. UOI***,[30] the question was not specifically about the SEBI's obligation, nonetheless, it was pronounced by

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[26] INDIA CONST., art. 14.
[27] Dr T.C. Barjatia v. State of Rajasthan, (2013) 6 SLR 715 (Ind.).
[28] Maneka Gandhi v. Union of India, AIR (1978) SC 597 (Ind.).
[29] Price Waterhouse v. SEBI, [2011] 108 SCL 216 (SAT) [hereinafter Price Waterhouse].
[30] KC Tandon v. The Union of India, AIR 1974 SC 1589 (India).

the apex Court that supply of relied on documents by the investigating authority based on which the law was set into motion would meet the requirements of the law, and the documents based on which the law is set into motion are only the relied upon or referred to documents.[31]

Furthermore, it was held by the Securities Appellate Tribunal ("**SAT**") in the case of ***Price Waterhouse v. SEBI,***[32] that it would not be a violation by the investigating authority if it refrains from supplying the not relied upon or not referred to documents.[33] Apart from this, it has been stated by the Supreme Court that it is no requirement that the appellant should be allowed inspection of all the material including the ones which have not been relied upon in the show cause notice.[34]

In contravention to this, Justice N.K. Sodhi, in the matter of ***Shruti Vora v. SEBI***,[35] as discussed above, has also opined that the entire material collected during investigations should be made available for inspection to the person whose conduct is in question, it shall help in the advancement of justice. It is imperative to ensure that the purpose of reaching the truth is fulfilled after providing an equal and fair opportunity to each party, and for this purpose, the Board is not entitled to select and supply the material as that would be unfair and unjust.[36] Nevertheless, the majority opinion in the same case, while interpreting the Regulation 6 of the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002,[37] reflected that there is

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[31] *Id.*

[32] Price Waterhouse, *supra* note 29.

[33] *Id.*

[34] Natwar Singh v. Director of Enforcement, (2010) 13 SCC 255 (India).

[35] Price Waterhouse, Opinion of Justice Sodhi, *supra* note 29.

[36] *Id.*

[37] Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2003, Gazette of India, pt. II sec. 3 sub-sec. (ii), Reg. 6 (July 17, 2003).

no duty cast upon the Board to disclose or provide all the documents in its possession especially when such documents are not being relied upon.[38]

Although the above-mentioned decisions provide a stance to the issue of supply of documents, however, they cannot be considered conclusive as the Apex Court is yet to provide an opinion on SEBI's obligation concerning the supply of documents. Considering that SEBI is not like every investigating authority, and is a separate body dealing with the securities market, the authors would share a divergent opinion considering several factors in a later section. However, before delving into the same, it is essential to analyse the stance of securities regulating bodies of other countries.

B. A JURISPRUDENTIAL COMPARATIVE ANALYSIS OF AMERICAN AND ENGLISH REGIMES

To determine if the system followed in India is upright or not, it would be helpful to do a comparative analysis with a few foreign common law jurisdictions. When it comes to analysing the securities market and its regulating bodies at an international level, the United States of America ("**USA**") and the United Kingdom ("**UK**") are the most suited countries considering their securities' regulation is the oldest and the most developed among all the common law countries.[39]

The countries under scrutiny, i.e., the USA and the UK both believe in applying the Principles of Natural Justice in the broadest way possible and this can be observed even while scrutinising their securities law regime as well. In the USA, the doctrine of "request for production of documents" makes it crystal clear that party is legally required to respond to a production request by either producing the material or offering a written explanation as to why the papers cannot be supplied. The most common justifications

[38] Shruti Vora, *supra* note 7.

[39] OFFICE OF US SEC, THE LAWS THAT GOVERN THE SECURITIES INDUSTRY, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry.

for not producing requested papers are that they are privileged, that they have been obliterated, that they are no longer in the control of the replying party, or that sending them would be excessively difficult.[40] This is, in fact, done so as to give the other party the basis of the allegation(s) imposed against it and so as to enable it to prepare its defence. Additionally, the same reasoning has been adopted by the UK legislators and judicial officers while framing their securities law(s) and deciding the cases under them.

With respect to the USA, where the Securities Exchange Commission ("**SEC**") is the securities regulator,[41] the law in relation to the supply of documents collected during the investigation is well established through both – judicial rulings and legislation. From a legislative point of view, if we refer to §201.230 of Part 201 of Rules of Practice,[42] it obligates the investigation authority to supply all the documents, except the ones that may breach privilege or confidentiality, collected during the investigation to the party investigated even before the proceedings begin. Moreover, Rule 34 of the Federal Rules of Civil Procedure ("**FRCP**") also provide that a party can request the documents which are in the possession of the other and the other party has to necessarily supply those documents including the ones collected during an investigation or inquiry.[43]

This stance is substantiated by the approach of the American judicial system which explicitly provided that according to Rule 34 of FRCP,[44]the law requires that SEC should provide all the documents and things

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[40] Peter Callaghan, *Understanding a Request for Production of Documents,* PAGEFREEZER BLOG (Jan. 27, 2021), https://blog.pagefreezer.com/understanding-request-production-documents.
[41] *Supra* note 39.
[42] SEC Rules of Practice, 17 C.F.R § 201.230 (2003).
[43] Fed. R. Civ. P., § 34 (1938).
[44] *Id.*

collected[45] during an investigation to the investigated party.[46] Further, it was also held that the need for documents collected during the investigation is an obvious requirement for the preparation of one's defence.[47] Moreover, it is an established rule in the USA that the public has a right to every man's evidence, which implies that a party has a right to access all the documents that are collected by the SEC during the investigation.[48]

Now considering the stance of the UK's legislation on the same subject, one can conclude after referring to the Enforcement Guide of the Financial Conduct Authority[49] ("**FCA**") that it is an obligation on the investigation authority to supply all the transcripts of an interview conducted by it,[50] along with providing the documents that were collected by the investigation authority during the said period of investigation.[51]

It should, from this point on, be noted that the legal systems in India, UK and US do not just converge on the point of applying the principles of natural justice in their daily affairs, but also in several other regards as well. These include the concept of limited separation of power, the usage of writ jurisdiction, and the application of the highly celebrated notion of rule of law. Nevertheless, it should be noted that there does exist some divergence amongst them considering that the Indian judiciary is more similar to that of the US than the UK, regardless of the fact that India adopted the parliamentary democracy system from the UK.

Thus, while the authors do agree that none of the legal systems is identical, there exist substantial similarities between them. In nutshell, the

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[45] Thomas C. Newkirk & Michael K. Lowman, *Document Productions in the SEC Investigations*, (Aug. 2019), in SEC COMPLIANCE AND ENFORCEMENT AB, PRACTISING L. INST., ch. 3, at 3-1 (David M. Stuart Ed., 2021).
[46] Cf. SEC v. Collins and Aikman Corporation, 256 F.R.D. 403 (S.D.N.Y. 2009).
[47] *Id.*
[48] Gould Inc. v. Mitsui Mining Smelting Co., 825 F.2d 676, 679-80 (2d Cir. 1987); Sporck v. Peil, 759 F.2d 312 (3d Cir. 1985); United States v. Bryan, 339 U.S., 323, 331 (1950).
[49] Enforcement Guide of the Financial Conduct Authority, Rule 4.11.4 (2022).
[50] *Id.*
[51] *Id.* at § 4.7.

basic tenet of observing and applying principles of natural justice are common to all three common law jurisdictions. Thus, granting the other party a fair chance to represent itself, is the most significant underlying principle of any common law legal sphere and must be respected in India as much as it is revered in the US and UK.

Furthermore, apart from the general similarity in the legal systems of these three common law countries, there is a commonality in the laws and procedures surrounding the securities markets in these countries. Statutory recognition of the securities market and the establishment of a separate body for resolving disputes relating to the securities market are a few examples of this commonality. The common characteristics are not restricted to substantial law but also the procedures that are followed by the dispute resolution bodies. Although the US has put much emphasis on arbitration as a dispute resolution method, nevertheless, when it comes to enquiry and proceedings by the statutory body, all the three countries have the same procedure. This comprises of providing a show-cause notice to the party getting investigated and taking decisions based on the party's response to the show-cause notice.[52] Along with this, the procedures also provide for equal opportunity and enough time for fair representation, etc.

Moreover, considering that we are living in a globalized world and capital markets are growing each day, cross-border transactions are becoming very frequent. This further increases the need to have a sense of similarity in the capital market laws of these economically dominant countries, especially the basic procedural requirements which also conform to the international standards of justice. The transparency obligation under the Principles of Natural Justice has been internationally acknowledged and

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[52] Ewan Brown et. al., *what are the relevant statutes and which government authorities are responsible for investigating and enforcing them?,* Global Investigations Procedure, (Nov. 19, 2021), https://globalinvestigationsreview.com/guide/the-guide-international-enforcement-of-the-securities-laws/first-edition/article/united-kingdom; *See also,* OFFICE OF US SEC, HOW INVESTIGATIONS WORK, (2017), https://www.sec.gov/enforce/how-investigations-work.html.

considered to be essential in order to give all the parties a fair chance of representing themselves so as to create a level playing field.

Therefore, it can be noted that the common law countries, which provide the basic guidance to India with respect to most of its legislations have indeed incorporated the basic transparency obligation of supplying information to the aggrieved. Hence, the Indian stance on this aspect, as elaborated above, is rather inflexible, and therefore, certain alterations are necessary in order to safeguard the rights of the aggrieved people.

IV. ANALYSIS AND CONCLUSION

As elucidated in the article, it is uncontested that the SEBI possesses wide powers, as has been recognised by the Supreme Court as well as other judicial authorities.[53] However, it should be noted that the sole constraint on such broad powers is the realisation of the fact that these powers must be exercised following the Constitution of India as well as the SEBI Act.[54]

Absence of bias, an opportunity of being heard before a decision is taken and the compulsory need to state reasons are the rules of natural justice that constitute the attributes of procedural fairness in democratic governance.[55] Even when an administrative order does not require an investigation, refusing to acknowledge the accused's solicitation to give testimony through a legal representative or supplying vital pieces of evidence to the accused is regarded as a refusal of a reasonable plea to justify oneself, and the core tenets of natural justice would be in jeopardy.[56]

The authors would also like to emphasise that articles 14 and 21 anchor the concept of *audi alteram partem*, which stipulates that nobody should be sentenced without having been represented. Numerous laws and regulations encompass clauses to guarantee that an individual against whom

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[53] Clariant International Ltd & Anr. v. SEBI, (2004) 8 SCC 524 (Ind.).
[54] *Id.*
[55] P. Leela Krishnan & Mini S., *Procedural Fairness in Administrative Decision-Making*, 59 J. INDIAN L. INST., 335,355 (2017).
[56] Delhi Transport Corporation v. DTC Mazdoor Union, AIR 1991 SC 101 (Ind.).

an action is likely to be taken receives notification before a decision is reached; however, there may be cases where an authority is entrenched with the jurisdiction to authorise such commands that impact a person's autonomy or assets, but the law does not entail a requirement for a prior hearing. It is important to note, nevertheless, that the implementation of natural justice principles is not dependent on any legal requirements.[57] Further, investigation reports are just as vital as inquiry records. Even if the injured party does not request the investigation findings, any measure undertaken without their perusal will be illegal and contradictory to the principles of natural justice.[58] In essence, therefore, it is an obligation upon the SEBI to provide all the documentary evidence to the accused because a supply of all the documents is a necessity for such a person to prepare his defence in a particular case.

In general, the authors believe that it is immaterial if the authority is relying upon the said material or not, or would the material be helpful to the requesting party or not,[59] rather it is imperative to ensure that the purpose of reaching the truth is fulfilled. [60] This purpose has to be fulfilled after providing an equal and fair opportunity to each party,[61] and therefore, the Board is not entitled to select and supply the material as that would be most unfair and unjust.[62] There can be no denial of access to the documents without a valid reason provided by the board.[63]

Additionally, the rule of reasonable opportunity requires that each party is given a full-fledged opportunity to present its case.[64] Hon'ble Supreme Court has held that the appellant is always entitled to have access to the

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[57]Cooper v. Sandworth Board of Works, (1863) 14 GB (NS) 4 180 (Ind.).

[58] Nagarjuna Construction Co. v. Government of AP, (2008) 16 SCC 276 (Ind.).

[59] Price Waterhouse, *supra* note 29.

[60] R.K. Aggarwal v. SEBI, (2001) 31 SCL 271 (Ind.).

[61] *Id.*

[62] Price Waterhouse, *supra* note 29.

[63] R v. Blundeston Prison Board of Visitors, ex parte Fox-Taylor, (1982) 1 All ER 646.

[64] The Collector v. K. Krishnaveni, W.A.No.1995 of 2018 (Ind.).

documents throughout the proceedings,[65] so that it could prepare its defence regarding the contents of the documents.[66] Moreover, in the matter of ***Kashinath Dikshita v. Union of India***,[67] the court held that failure to supply materials might be tantamount to the denial of a reasonable opportunity to the appellant to defend himself. During the proceedings, the role of the Board is that of an adjudicator, and not of a prosecutor,[68] because of which, the board cannot determine what documents would be relevant for the other and what not. Supply of all the documents will facilitate the investigated party in preparing a strong and complete defence, and simultaneously help the court in meeting the ends of justice by ensuring compliance with the principles of natural justice. This supply of all the documents shall also have a bearing on India's relations with countries that have strong security laws regime. These days, with the ever-growing technology and connectivity, and rise of globalization, the horizon of Indian securities market has also become international and investors are pouring in from all around the world. Moreover, with the development of international laws and inter-dependency among countries, it has also become imperative that countries align in their views in relation to judicial processes and rights of accused/investigated parties. Therefore, if Indian securities laws regime align with that of its contemporaries, it could help India in creating strong relations with these countries as it would serve the vested interest of investors from these countries as well.

V. CONCLUSIVE REMARKS

In light of the analysis done above, authors believe that their hypothesis, which was that there exists a loophole in the investigation process of SEBI because of non-compliance with the principles of natural justice and non-provision of an equal opportunity to the investigated party, was correct. This loophole requires to be resolved either through an amendment by the

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[65] Uttar Pradesh v. Saroj Kumar Sinha, (2010) 2 SCC 772 (Ind.).
[66] Ms. Smitaben N. Shah v. Securities and Exchange Board of India, Appeal No. 37/2010 (Ind.).; *See also* Shruti Vora, *supra* note 7.
[67] Kashinath Dikshita v. Union of India, (1986) 3 SCC 229 (Ind.).
[68]KC Tandon v. Union of India, AIR 1974 SC 1589 (Ind.).

legislature or through a conclusive stance by the Supreme Court on the impugned issue as it would ease out complexity which exists in the investigative process of the SEBI. For instance, there is a dispute between "A" and an administrative body "B". Here, A was holding an administrative post and there were charges of misconduct against him. During the investigation, the Disciplinary Authority of the administrative body B utilised witnesses and other documentary evidence to dismiss A from his post. Now, if A does not get the copies of statements of the witnesses recorded ex-parte at the pre-enquiry stage and the documents on which the whole accusation against him and his subsequent dismissal is based, then, he will not be able to understand the allegations against him in-depth, and thus will not be able to prepare his defence and represent himself in the Court of Law. This is a blatant breach of his fundamental rights as enshrined under the Constitution. Therefore, the authors submit that it is indeed essential to supply all the documents collected during an investigation by the SEBI to the accused in order to hold a fair trial and respect his fundamental rights.

Lastly, as elucidated by the authors, even other Common Law nations like the United States and the United Kingdom follow the basic tenet of providing the accused with all the documents that have been utilized against him. Hence, it is reasonable to contend that SEBI's investigative powers should also take guidance from the English Laws and other similar laws prevalent in sister Common Law nations. Therefore, the authors conclude that when the Indian securities laws have been redrafted in a more flexible and "accused-friendly" manner, then only the true sense of justice can be said to be achieved.

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