Introduction to Corporate Governance

Corporate governance is the system of rules, practices, and processes that directs, controls, and holds a company accountable to various stakeholders—shareholders, management, employees, customers, and regulators. It aims to balance interests and ensure transparent, ethical decision-making for long-term success.

Need for Corporate Governance

- **Investor Confidence**: Well-structured governance boosts trust among investors by ensuring accountability and transparency.
- **Risk Management**: Effective governance identifies, monitors, and mitigates risks—strategic, financial, operational, or reputational.
- **Ethical Conduct**: Upholds responsibility and fairness, reducing fraud, misconduct, and reputational harm.
- **Regulatory Compliance**: Ensures legal adherence, minimizes fines and sanctions, especially in regulated sectors.
- **Reputation & Sustainability**: Enhances organizational reputation, attracts quality employees, customers, and investors.

Pillars of Corporate Governance

Commonly defined pillars include:

1. **Accountability**: Clear responsibility for decisions and performance.
2. **Transparency**: Open and accurate disclosure of actions and performance.
3. **Fairness**: Equitable treatment of all stakeholders, including minority shareholders.
4. **Responsibility**: Ethical obligation to act in the best interests of the organization and society.
5. **Integrity**: Adherence to ethical standards and moral conduct.
6. **Effective Engagement**: Interaction with shareholders and stakeholders to strengthen trust.

History and Development

- **Ancient & Early Commerce:** Trade guilds and collegia in Roman times had early governance structures emphasizing accountability.
- **17th–18th Century:** Emergence of joint-stock companies like VOC and EIC introduced shareholders and boards.
- **19th–early 20th Century:** Limited liability formalized, shareholder rights & board oversight evolved.
- **Post-WWII:** Increased scale of firms shifted focus onto agency problems (manager vs shareholder interests).
- **1990s-Onwards:**
    - 1992: UK Cadbury Code established governance benchmarks; likewise Ireland’s IAIM code slightly earlier.
    - 2002: US Sarbanes–Oxley Act strengthened control, transparency, and auditing norms.
    - 2020s: ESG, board diversity, and stakeholder-centric governance frameworks gaining prominence—e.g., OECD Principles update in 2023.

International Regulatory Framework

- **OECD & G20/OECD Principles**: Widely accepted standards emphasizing board roles, transparency, and stakeholder rights. Revised in 2023 to include sustainability, resilience, and ESG.
- **OECD Factbook**: Offers country-level data on governance models and regulatory systems across 52 jurisdictions.
- **International Codes**:

- UK Corporate Governance Code (Cadbury, Hampel, UK Code);
- India: Clause 49; Companies Act 2013; SEBI Listing Regulations

Case Studies

📉 **Harshad Mehta Scam (1992)**

- **Modus Operandi**: Mehta exploited bank receipts and ready-forward deals, extracting ₹1,439 crore (~$3 billion) from banks and inflating select stock prices to sell at peak.
- **Governance Failures**:
  - Exploitable regulatory gaps in banking and securities markets
  - Weak internal controls at banks
  - SEBI's limited authority until becoming statutory in 1992
- **Aftermath & Reforms**:
  - SEBI transformed into a statutory body on 30 January 1992
  - Enhanced disclosure framework, simplified IPO procedures, stronger investor protection
  - Stronger insider trading and compliance mechanisms
- **Governance Lessons**:
  - Regulatory authority is key
  - Continuous control mechanisms to prevent large-scale fraud
  - Proactive oversight vs reactive sanctioning

Karvy Stock Broking Scam (2019–2020)

- **Modus Operandi**: Karvy misused client PoAs to pledge securities worth Rs2,300–2,700 crore as collateral for loans to its group firms—impacting 95,000+ investors.
- **Governance Failures**:
  - Weak internal checks over PoA usage and client asset management
  - Violations of SEBI Stock Broker Regulations
- **Regulatory Response**:
  - SEBI barred new client acquisitions, penalized Karvy and its MD (~₹25 crore), attached assets and demat accounts to recover dues
  - Flooded calls for stronger PoA norms, risk oversight and real-time monitoring
- **Investor Claims**:
  - NSE/BSE invoked Investor Protection Fund: caps set (₹35 lakh and ₹16 lakh respectively)
  - Clients required to file claims with supporting documentation by specified deadlines
- **Governance Lessons**:
  - Importance of independent custody of client assets
  - Unauthorized asset pledging must be prevented
  - Regular audits and real-time surveillance are critical

Conclusion

Corporate governance has evolved through regulatory learning and regulatory responses to high-profile scandals. Core pillars—accountability, transparency, fairness, responsibility, integrity, and engagement—form the bedrock of this evolution. Continuous strengthening of regulatory frameworks, institutional vigilance, and systemic risk checks are essential to restore and maintain investor trust. Studying the Harshad Mehta and Karvy cases offers critical insights that can help shape governance policies and compliance mechanisms for future resilience.

Genesis and Evolution of Corporate Governance

Corporate governance, as a concept and practice, has evolved over several centuries. Its development is closely tied to the growth of corporations, financial markets, and the need to balance power between owners, managers, and stakeholders.

1. Early Roots (1600s–1800s): The Beginning of Modern Corporations

a. Birth of Joint-Stock Companies

- The genesis of corporate governance can be traced to the formation of the **East India Companies** (Dutch East India Company – 1602, English East India Company – 1600).
- These early corporations had **multiple shareholders**, which created the first instances of separation between **ownership** and **management**.

b. Need for Accountability

- As businesses grew beyond individual or family control, investors demanded:
  - transparency,
  - accountability,
  - protection from mismanagement.

This laid the groundwork for early governance mechanisms.

2. Industrial Revolution (1700s–1800s): Rise of Large Enterprises

a. Expansion of Capital Markets

- Industrialisation required **large capital investments**, leading to widespread use of joint-stock companies.
- Shareholding became common, and ownership dispersed.

b. Emergence of Agency Problems

- With professional managers running companies, the **principal–agent conflict** became a core governance issue.
- Legislations like the UK's **Joint Stock Companies Act, 1844** and **Limited Liability Act, 1855** established:
  - registration requirements,
  - liability limits,
  - formal governance structures.

These laws are foundational to the modern corporate governance framework.

3. Early 20th Century: Shareholder Democracy and Legal Foundations

a. The Berle–Means Thesis (1932)

- In *The Modern Corporation and Private Property*, Berle & Means observed:
  - Separation of ownership and control,
  - Dominance of managers over shareholders.
- This academic work highlighted the need for stronger governance mechanisms.

b. The Great Depression (1929)

- Corporate scandals and market failures exposed governance weaknesses.
- The U.S. responded with:
  - **Securities Act, 1933**
  - **Securities Exchange Act, 1934**
  - Formation of the **SEC**

These established disclosure norms, auditing standards, and investor protection — key pillars of governance today.

4. Late 20th Century: Corporate Scandals and Global Governance Reform

a. 1970s–1990s: Corporate Failures and Calls for Reform

Significant failures like:

- Penn Central (1970),
- Lockheed bribery cases (1970s),
- BCCI, Maxwell (1991),

exposed fraudulent practices, weak boards, and audit failures.

b. Cadbury Committee Report (UK, 1992)

- The most influential modern governance document.
- Recommended:

    - independent directors,
    - separation of CEO and Chair roles,
    - audit committees,
    - stronger disclosure.

This report triggered a global wave of governance codes.

5. Early 2000s: Major Scandals & Strengthening Governance

a. Enron, WorldCom, Tyco (2001–2002)

These global scandals revealed:

- accounting fraud,
- board failures,
- auditor conflicts of interest.

b. Sarbanes–Oxley Act (SOX), 2002

SOX introduced:

- CEO/CFO certification of financial statements,
- independence of audit committees,
- severe penalties for fraud,
- enhanced internal controls (Section 404).

SOX significantly strengthened the governance framework worldwide.

6. Globalization and the Rise of International Governance Standards (2000s onward)

a. OECD Principles of Corporate Governance (1999, 2004, 2015, 2023)

These principles became the **global benchmark**, covering:

- shareholder rights,
- disclosure,
- board responsibilities,
- stakeholder relations.

b. Influence of Institutional Investors

- Growth of pension funds, mutual funds, and sovereign wealth funds reshaped governance.
- Stewardship codes emerged (Japan, UK, India).

c. ESG and Sustainability Governance

From 2015 onwards, governance expanded to include:

- environmental responsibility,
- social impact,
- climate risk reporting,
- diversity on boards.

ESG-based governance is now central to corporate strategy and investor decisions.

7. Digital Era (2020s): Technology, Transparency, and New Governance Challenges

a. Rise of Digital Governance

New issues have emerged:

- cybersecurity,
- data privacy,
- algorithmic decision-making,
- AI ethics.

Boards are now expected to have digital expertise and oversee technology risks.

b. Stakeholder Capitalism

- Shift from shareholder primacy to stakeholder governance.
- Companies are expected to balance financial performance with:
    - employee welfare,
    - environmental responsibility,
    - community impact.

c. Global Convergence of Standards

- IFRS sustainability standards (ISSB, 2023),
- EU Corporate Sustainability Reporting Directive (CSRD),
- updated OECD Principles (2023).

These are moving corporate governance toward universal frameworks.

Summary Timeline

Period	Key Developments
1600s–1800s	Birth of corporations; early shareholder rights
Industrial Revolution	Separation of ownership & management; corporate laws emerge
1930s	SEC formation; disclosure norms after the Great Depression
1990s	Cadbury Report; modern governance codes introduced
2000s	SOX after Enron; strong board & audit controls
2010s–2020s	ESG, stewardship codes, global standards, tech governance

Role of the OECD in Corporate Governance

The **Organisation for Economic Co-operation and Development (OECD)** plays a central and influential role in shaping global corporate governance practices. Its major roles include:

1. Setting Global Standards

- The **OECD Principles** are recognized worldwide as the benchmark for best corporate governance practices.
- Adopted by G20 nations and used by regulators, stock exchanges, investors, and companies globally.

2. Guiding Policymakers and Regulators

- Provides practical guidance to countries on strengthening:
    - company laws,
    - securities regulations,
    - board practices,
    - disclosure norms.
- Helps governments design reforms aligned with global standards.

3. Promoting Market Confidence and Investor Protection

- Enhances trust in financial markets by encouraging:
    - fair treatment of investors,
    - prevention of fraud,
    - transparent disclosures,
    - strong internal controls.

4. Supporting Corporate Governance in Emerging Markets

- Works with developing countries to improve governance frameworks.
- Assists through capacity-building, peer reviews, and regional roundtables.

5. Encouraging Responsible Business Conduct

- Integrates ESG, sustainability, and stakeholder considerations into governance.
- Issues guidelines on:
    - environmental responsibility,
    - ethical conduct,
    - human rights and supply-chain due diligence.

6. Facilitating International Cooperation

- Brings together regulators, academics, companies, and investors from across the world.
- Promotes dialogue and harmonization of governance standards between countries.

OECD Principles on Corporate Governance

The OECD Principles of Corporate Governance (most recently revised in 2023) serve as one of the world's leading benchmarks for sound corporate governance. They aim to assist governments, regulators, corporations, and stakeholders in improving transparency, accountability, and performance in both public and private sector companies.

1. Ensuring the Basis of an Effective Corporate Governance Framework

Key Points

- **Clear legal and regulatory framework:**
  Governance structures must rely on a stable legal and regulatory environment that promotes market transparency and integrity.
- **Consistent with rule of law:**
  The framework should align with national laws while supporting enforcement through independent regulators.
- **Efficient supervision and enforcement:**
  Strong institutions, well-resourced regulators, and predictable enforcement mechanisms are critical.
- **Promoting fair and competitive markets:**
  Markets should function without distortions, ensuring equal access to information and a level playing field.
- **Flexibility & adaptability:**
  Regulations should evolve with changes in technology, markets, and global norms.

Objective

To create a foundation that enables boards, shareholders, and stakeholders to operate in a fair, transparent, and efficient environment.

2. The Rights and Equitable Treatment of Shareholders and Key Ownership Functions

Shareholder Rights

- Secure ownership registration.
- Transfer of shares without undue restrictions.
- Timely and reliable access to relevant corporate information.
- Participation and voting in general meetings.
- Selection and removal of board members.
- Share in profits through dividends.

Equitable Treatment

- All shareholders, including minority and foreign shareholders, must be treated fairly.
- Prohibit insider trading and abusive self-dealing.
- Related-party transactions must be transparent and subject to appropriate approval mechanisms.

Key Ownership Functions

- Effective participation in key decisions such as mergers, asset sales, or changes to capital structure.
- Ability to influence corporate strategies through voting and engagement.
- Rights to voice concerns and seek redress in cases of breaches.

3. Institutional Investors, Stock Markets, and Other Intermediaries

Institutional Investors

- Should disclose their ownership policies, voting guidelines, and engagement practices.
- Expected to act responsibly, particularly when holding significant stakes.
- Encouraged to manage conflicts of interest transparently.

Stock Markets

- Must uphold fair, efficient, and transparent operations.
- Listing rules should promote good governance, including timely disclosures.

- Exchanges should facilitate enforcement of governance standards.

Intermediaries (Analysts, Rating Agencies, Proxy Advisors)

- Should maintain independence and avoid conflicts of interest.
- Required to disclose methodologies and potential influence on corporate behaviors.
- Play a crucial role in providing quality information to investors.

4. The Role of Stakeholders in Corporate Governance

Definition

Stakeholders include employees, creditors, suppliers, customers, and the broader community.

Key Principles

- Respect legal rights and contractual obligations of stakeholders.
- Encourage active cooperation between corporations and stakeholders that adds value, such as:
  - employee participation,
  - codes of conduct,
  - sustainability reporting.
- Provide avenues for whistleblowing and stakeholder redress.
- Promote responsible business conduct, including ESG commitments.

Importance

Stakeholder engagement strengthens long-term corporate success, reduces risk, and aligns corporate activity with societal values.

5. Disclosure and Transparency

Essential Disclosures

Companies must provide accurate and timely information on:

- Financial results and audited statements.
- Ownership structure and control mechanisms.
- Governance policies and board composition.
- Related-party transactions.
- Risk factors and risk management systems.
- ESG matters: sustainability, climate-related risks, social impacts.

Quality of Information

- Information must be relevant, reliable, comparable, and easily accessible.
- Audits should be conducted by independent, competent auditors.
- Digital disclosure channels should ensure wide and equal access.

Objective of Transparency

Enhances investor confidence, facilitates market functioning, and reduces information asymmetry.

6. The Responsibilities of the Board

Core Responsibilities

- **Strategic leadership:**
  Approving corporate strategies, major plans, and budgets.
- **Oversight of management:**
  Selecting, compensating, monitoring, and if necessary, replacing the CEO and senior management.
- **Risk management:**
  Ensuring appropriate systems for managing financial, operational, ethical, and ESG risks.
- **Ensuring integrity of reporting:**
  Overseeing internal controls, audit processes, and accuracy of disclosures.
- **Ethics and compliance oversight:**
  Promoting a culture of compliance and ethical business conduct.

Board Composition

- Mix of executive, non-executive, and independent directors.
- Diversity of skills, backgrounds, and perspectives.
- Use of board committees (audit, nomination, remuneration, risk) for effective functioning.

Accountability

Boards must act in the best interests of the company and all shareholders, with due regard for stakeholders and long-term sustainability.