

Corporate Governance and Investor Protection: Role of Statutory Board Committees Under the Companies Act 2013

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Abstract

With the rise of venture capitals, hitting a certain funding benchmark defines the current era of industrial development. At the initial stages of capital-led growth, with “going public” seen as the ultimate goal of corporate players, a discussion around corporate governance would be timely. Investor protection, arguably, has more relevance in the corporate world today than ever, and as such, studying corporate governance from the lens of investor rights, particularly within the matrix of the Companies Act, 2013, is helpful for the burgeoning corporate sector in India. This article, in its first part, seeks to analyze the underlying hurdles in the enforcement various investor rights in a company and why there is a need to safeguard them. In the second part, a discussion on proper corporate governance and its role in investor protection is undertaken. In this part, the significance of board committees as an important part of this structure is highlighted. In the third part, three statutorily mandatory committees and their individual roles in investor protection are discussed, along with their shortcomings that indicate the scope for improvement in the provisions that deal with them. The concluding part reports the major findings of the analysis undertaken.

Keywords: Venture capitals, corporate players, Investor protection, corporate governance, investor rights, Companies Act 2013

INTRODUCTION

A Discussion on Investor Rights and the Need for Investor Protection

Most companies need external financing for their constitution, since the capital involved is so enormous that generally it is exceeding the resources of any single person or entity [1]. Moreover, due to the risk associated with business ventures, parties generally seek to spread out the risk among many interested parties who are willing to share it by investing their capital into the venture, in lieu of some sort of returns. These interested parties are termed as “investors” who contribute to the capital of a company in exchange of financial returns, and even ownership in case of stock or shareholders. Being

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an investor comes with a bundle of rights, however, they also vary with the kind of investor, for instance being an shareholder comes with the right to be aware of the companies affairs, to be able to participate in the decision making process of the company, if such a decision affects their rights, right to appoint the managers of the company who will ultimately carry out the affairs of the company, however, certain rights are common to every investor—right to fair returns on their investment subject to their individual contractual terms, and the right not to have their capital investment siphoned off or used in a manner prejudicial to the

interest of the venture. Effective utilization of the rights also calls for a proper grievance redressal forum at place. However, due to the structure of the company there are certain hurdles that come in the way of investor rights.

The ownership-management dichotomy is a common characteristic of most companies/ or corporations, with the management—professional managers and other corporate insiders, exerting authority over most key decisions of the corporation on behalf of the owners or other investors, acting effectively as their agents [2]. As much as this separation is indispensable in the efficient running of a corporation, it also is inevitably linked with certain problems collectively known as *agency problems*. The acts of the managers are final, barring in exceptional circumstances, restricted only by the Articles or by mandatory provisions of law, and due to the deference accorded to the acts of the managers by the courts and the law using the doctrine of “business judgment,” [3] the discretion left at their hands is ample, and can be potentially misused by them given the presence of competing interests of both the factions. Since the managers are entrusted with managing money that does not belong to them (or only part of it does) their tendency to appropriate parts of it for their own consumption, in the absence of proper monitoring mechanism in place, always lurks [4].

This leads to the obvious conclusion that there exists a clear conflict of interest at the heart of this agency relationship, with the investors’ objective being profit maximization, and manager’s being siphoning more resources as “perquisites” [5]. Misalignment of interests only forms part of the problem that emerges out of this dichotomy; another major problem that creeps in is that of a “moral hazard.” The owners cannot effectively observe each and every action of the manager, since they neither have the time, nor the technology to do so, [6] and given, commercial contracts are incomplete by design in order to accommodate any unforeseen event, the managers will often be left with no instructions and ample discretion. Naturally, more diffused the ownership pattern gets, more difficult it is for individual investors to exert control over the managers, and consequently more difficult it gets to monitor their activities. Therefore, the manager can enjoy a certain degree of latitude while performing her tasks, and can generally in the absence of pertinent checks, get away with investing less than her best efforts, which results in “shirking” [7].

Since corporations are a complex network of contracts, [8] and each corporation a different superstructure than the other, the agency problem varies in extent as well as type. This variation is not only apparent among corporations inter se, but there is another set of agency problems on the basis of plausible conflicts, that exists within the corporation itself—between the owners and the creditors, where the former acts as the agents of the latter, [9] in lieu of their investment. Since the owners typically function through the managers, the fulfillment of this duty also ultimately rests with the managers, who then with their actions, possess the capability to impact another class of investors—the creditors, apart from shareholders directly, as well. This “debt agency” problem is illustrated by sub-optimal investment decisions that do not conform to the requirement of value maximization [10]. With higher creditor risk, the market appeal or value of the firm falls if enough assurances do not exist that actions of the firm would not be turned to creditor disadvantage. This entails a higher cost of debt financing, which ultimately falls on the owners. In order to recoup the extra cost, the appetite of risk taking, might significantly, perhaps inevitably increase, leading to excessive risk-taking which might negatively affect the firm on the whole.

Over time, the managerial agency problem that affects investors, largely manifests itself in the two forms discussed above—firstly, siphoning off resources at the expense of the investors, and secondly, low risk or safe but inferior investment decisions that provides security of tenure and compensation to the managers, that stems from the possibility and willingness to “shirk,” both of which lead to economic inefficiency. In other words, under these conditions the firm performance would be “sub-optimal” or below “pareto optimal,” [11] which not only impacts the investors, but in the long run also has repercussions on the economy by virtue of wealth destruction. Investor protection thus becomes an extremely significant objective of the law.

INVESTOR PROTECTION THROUGH CORPORATE GOVERNANCE: BOARD COMMITTEES

Protection of investor rights pre-requires a system of checks and balances, which ensures that such agency conflicts are kept to a minimum. As a result, an entire branch of Corporate Governance has evolved that eases agency problems, by limiting managerial actions that are considered to be inefficient and undesirable. In fact, “Corporate Governance” has been defined as a set of systems, processes, and principles that ensures that a company is governed to the best interests of all the stakeholders of that company [12]. Since the effectiveness of any corporate governance mechanism is extremely dependent on the effectiveness of the Board of Directors—the primary body tasked with monitoring those at the top managerial rungs, [9] the composition and manner of functioning of the Board is a central concern of corporate laws. The law will seek to enforce the corporate governance mechanism through stipulating conditions for composition as well as manner of functioning, to enable it to perform its monitoring task with full effect. Independence, capacity to demand accountability, and specific knowhow of the matter monitored are the goals that the law seeks to achieve when mandating composition and functioning, and it achieves so by dictating mandatory minimum number of independent directors in the board and formation of smaller, specialized and partly independent groups within the board called—committees. Since board committees are specialized groups, each tasked with different categories of responsibility in the set up, they possess the ability to carry out these singular facets of corporate governance more efficiently, than a general body like the Board itself. This article’s primary focus would lie on the role of board committees in “investor protection” [13]. In doing so, the scope would be restricted mainly to the three committees that possess statutory mandate under the Companies Act, 2013, namely the nomination and remuneration committee, the stakeholder relations committee, and the audit committee. The article firstly aims to identify the agency problem that each of them seek to remedy and then assess their functioning to conclude whether they remedy the same sufficiently, in order to protect investor rights.

ROLE OF THE COMMITTEES IN INVESTOR PROTECTION

Nomination and Remuneration Committee

The Kumar Mangalam Birla Committee constituted by SEBI in 1999 to raise the standards of good corporate governance recommended the setting up of a remuneration committee, as part of its non-mandatory suggestion, citing the reason of having a transparent and credible policy responsible for determining remuneration and compensation of directors as a must. In 2013 the Companies Act officially made provisions for setting up of a mandatory Nomination and Remuneration Committee for companies that possessed a certain qualification. § 178(1) of the Act read with Rule 6 of the Companies (meetings of Boards and its Powers) Rules, 2014 requires that every listed company, all public companies with a paid-up capital of or more than Ten Crore Rupees, all public companies having a turnover of or more than One hundred Crore Rupees, and all public companies with outstanding loans/borrowings/debentures/deposits exceeding an aggregate of Fifty Crore Rupees or more must mandatorily constitute this committee. The section also prescribes its composition—three or more non-executive directors, with more than half of them being independent directors, with the stipulation that the Chairperson of the company though can be a part, yet never chair this committee, which indicates the obvious effort to keep the board immune to undue influence. One prong of its responsibility is to formulate criteria for qualification and independence of directors, and to select and nominate candidates for directorship as well as for the top core management cadet of the company, according to those criteria. Independence of this committee secures the appointments from being infested with undue influence from particularly concentrated shareholding patterns or those who already exert managerial control. It is in the nature of a precautionary provision, so far it seeks to moderate managerial behavior right from their appointment, by ensuring the criteria for their selection is laid down as objectively as possible, in order to preclude the rise of a chunk of problems that co-exist with favoritism at top managerial posts. The committee must fulfill this objective by formulating the necessary criteria for qualification that rejects bias but that does not compromise with efficiency. In other words, it checks against the agency problem of *conflicting interests* that possibly exists between the managers and the investors. With the

former's objective ranging from pure bias in benefitting individuals who share ties of familiarity with them, to an ulterior motive of concentrating power by appointing directors and managers that are no more than puppets at their hands; and the investors', who on the other hand, want individuals with the ability to bring innovative and strategically significant ideas to the table, a situation arises which clearly demonstrates battling interests. This is effectively taken care of if the selection is based on an objective criterion that aligns with the interest of the company as a whole rather than the managers alone. This committee is also made responsible for evaluating the performance of the directors and managers, and accordingly suggesting their removal if the need be. It, thus, acts as a thorough and thorough check on the manner of discharge of duties by the managers and directors by attempting to keep the managers' propensity to digress from their best efforts, under reasonable check. It demonstrates efforts on part of the law to provide for an effective monitoring mechanism to deal with the problem of *moral hazard*. Since the managers are now aware of the fact that there is a behavior monitoring mechanism at place that is endowed with the ability to cause consequential damage, they are compelled to an extent to ally their actions with the best interest of the company. So far with these powers, the committee attempts to remedy both of the central problems in agency—conflict of interest and the lack of best efforts, to an extent. The other prong of its primary task is to determine a suitable policy governing the remuneration of the managers and directors that befits their duties, and at the same are commensurate with their level of performance in the firm [14]. While arriving at a given formula, the committee has to judge the sufficiency of the quantum of remuneration, against a dual parameter apart from performance levels—firstly, being adequately attractive to incentivize the managers to perform their duties faithfully, and secondly, keeping the interest of the short-term and long-term goals of the company in mind, and value maximization of the least amount of money payable [15]. This performance based-incentive intensive approach seeks to align the interest [16] of the managers with that of the company's long-term goals, by encouraging the managers to take decisions that are most expected of them, and to achieve results that benefit the company in order to be eligible for appropriately higher remuneration [17]. In fact, this incentivizing approach when coupled with the threat of being relieved from the post, acts as a consolidated force trying to align the competing interests in the dichotomy. In doing so, the managers are compelled to ensure that they do not “shirk,” for this time it goes against their own interest. This aspect of their role seeks to remedy one problem through resolving the other. Remedying agency conflicts ultimately leads to greater investor satisfaction since the agents are forbidden from pursuing their individual interests at the cost of the latter. All investors benefit from better firm efficiency, as that ensures proper returns on their investment.

While the role assigned to this committee appears to be an optimal solution for resolving agency conflicts in theory, there still exists a gaping loophole in this scheme. Since the decisions of the committee are recommendatory in nature, none of the proposals are absolutely binding on the Board, the law being silent on what follows a disregard of those recommendations [18]. Although other regulatory bodies can remedy this anomaly by taking appropriate actions given Regulation 19 of the SEBI Listing Obligations and Disclosure Requirements Regulations 2015, imposes a similar requirement upon the companies, nevertheless the shortfall in the statute continues to exist. This means there is no statutory backing to a complaint based on non-observance of the committee's policies. Another issue that becomes pertinent to be discussed is that the law does not provide even a bare minimum of a guideline as to how performance and remuneration should interconnect. It is absolutely silent on what type of performance benchmarks should be proper while formulating policies, rendering the set up liable to possible misuse. This leaves open the possibility of the same conflicts it sought to remedy, seeping through in the process by which it attempted to do so. However, arguably the biggest problem that could arise practically is doubt on the competency of the committee in evaluating the performances of the managers and directors, for such evaluation entails a certain level of involvement in the core management of the company's affairs in order to come up with accurate results. However, since all the members of this committee must be non-executive directors who are not directly involved in the day-to-day functioning of the company, the evaluation can be called into question on the above ground. Though this set up can function with some inevitable collaboration between the management and the committee, the reliability of which again is doubtful, the decisions and the policy of this

committee is nevertheless always open to questioning on the ground that it probably trades off efficiency for transparency. Even if this problem can be discarded as a necessary evil in resolving agency problems by providing transparency, the question still remains at what cost a company should pursue transparency, when the original objective was to acquire more efficiency through transparency. Since active monitoring alone cannot lead to better performance and optimal results, the composition of the committee can be a recurring problem. Though there is lack of direct correlation between committee structure and firm performance, a study has proved that insiders or executive directors can be valuable members of board committees [19], if the independence is not compromised. In fact, market is conscious of this phenomenon and actively rewards firms who incorporate such insiders in their boards to achieve optimal results, which might not be completely feasible in all outsider boards [20].

Stakeholders Relationship Committee

Investing in a firm accords the investors a cluster of rights and powers, and proper corporate governance should ensure that mechanisms like disclosure requirements, and accounting standards are adhered to in order to facilitate the availability of requisite information to the investors enabling them to exercise these rights effectively [21]. However, the role of corporate governance with regard to investor protection is not restricted to facilitate information only; it further extends to providing an appropriate grievance resolution forum. The Companies Act, 2013 meets this objective through the mandatory requirement of having a Stakeholders Relationship Committee in every company. Though the Listing Agreement also provides for such a committee, but §178(5) of the Act makes it applicable to both listed as well as non-listed companies having more than one thousand stakeholders, where stakeholders represent all kinds of security holders—shares, debentures, or deposits [22]. The committee has the sole responsibility of receiving and resolving grievances of various security holders that might arise due to either of the two central agency problems discussed above. Thus, this committee is a direct attempt at good corporate governance—securing and enforcing investor rights by way of a separate forum to make the process more expedient.

While it is commendable to have a dispute resolution mechanism at place catering specifically to the class of investors, the provision on a deeper probe only does lip service to the cause of investor protection. The provision comes across as rather rudimentary and ineffective, given there has been no guideline as to the method of implementation and the timeframe within which such problems must be resolved. Furthermore, there is no provision for any appellate forum when the problem is not resolved to the satisfaction of the parties or not resolved at all. While this does provide the companies with a degree of flexibility, it also creates a loophole which can be abused to circumvent the purposes of this section. Regulation 13 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, which deals with the similar issue for listed companies, provides for a more comprehensive mechanism that requires the formulating and placing a quarterly report before a recognized stock exchange, on the number of grievances received, number of them resolved, and number of them pending. It also requires the same to be placed before the Board of Directors every quarter. The Act seems to have conveniently dropped this requirement from its provision, rendering the entire section to be good only on paper. The prescription of the threshold does not seem to further the cause of the committee either. Since the committee is committed to the cause of resolving investor grievances, prescription of a numerical threshold seems quite arbitrary, on the other hand it leads to an anomalous conclusion that investor issues in companies having anything less than one thousand investors do not require attention, even though the capital involved could be much higher in the second case, for instance in companies with large capital but more concentrated shareholding patterns. Moreover, the threshold requirement creates a conflicting position with regard to listed companies as companies that do not cross the threshold have an option of not constituting this committee under the Act, whereas under the SEBI (LODR) Regulations, due to the absence of any minimum qualification prescribed, they are under an obligation to constitute one. Perhaps, a little more clarity could have been bestowed upon the provision for it to have translated into a more holistic and effective investor protection mechanism, which it falls short of currently.

Audit Committee

The concept of an 'Audit Committee' first got recognition in the U.S. in the context of McKesson Robbins Inc. investigation in the year 1940. The Securities Exchange Commission—the principal securities regulatory body of the United States, realized the need for an independent body to oversee the audit functions to raise the standard of proper business conduct, in light of the scandal. In India, the Amendment Act of 2000 [23] introduced the audit committee, after the 164th report of the Parliamentary Standing Committee recommended the same. The primary purpose of the committee being strengthening the Management Information System in India, the body was conferred with significant powers. The principal task of the committee is to review the company's financial statements and the auditors' reports, and internal accounting controls and demand an explanation for any discrepancy. Along with this it also must monitor the company's auditors' effectiveness in carrying out the task, and their independence. This being a challenging yet extremely significant vigil process ensures a double check on the company's accounting standards. This in turn helps tackle the agency problems arising out of information asymmetry between the insiders and the investors, by facilitating the disclosure of crucial account related information in a timely manner.

However, apart from these duties, this committee is also entrusted with *five* other extremely crucial responsibilities that strengthen investor confidence in the corporation. By virtue of § 177(4) (iv) of the Act the audit committee must oversee and approve all related party transactions [24]. These transactions considered to be high risk transactions, for they entail a potential abuse of Directors' duty, attract heightened scrutiny by the general scheme of the act itself. However, this additional check on such transactions by the audit committee provides for an even stricter inspection: since under § 188(1) proviso [25] such transactions which are in the ordinary course of business and entered into at arm's length basis are exempted from the requirement of a prior Board approval, but under this section no such exemption has been granted, meaning *all* related party transactions must be approved by the committee without fail. Moreover, the committee has an extraordinary power to modify any such transaction subsequently as well. Furthermore, unlike the Board, the committee has been given an explicit "power to obtain professional advice from external sources and have full access to information contained in the records of the company" [26]. Reading the proviso, which was added after the 2015 amendment to the section, with Rule 6A of the Companies (Meetings of Board and its Powers) Rules, 2014, the committee can also grant an omnibus approval [27] to all such transactions, after it has specified the criteria for the same which must indicate the maximum value per transaction to be allowed and list of required disclosures to the Audit Committee that must be made at the time of seeking such approval, while the repetitiveness of such transactions in the past or future, and the justification on part of the company for the need of such an omnibus approval must form part of consideration before such approval. The committee must also ensure that such an approval is in the interest of the company, and it must review such transactions granted after the approval, at certain appropriate intervals. This burdensome responsibility which has been placed on the committee is representative of the law's effort to channelize such high-risk transactions through a body more independent and perhaps more specialized in financial matters than the board. The committee is accorded the power to protect the corporation's and effectively the investor's interest from any abuse of power, arising out of cases that involve a very degree of conflicting interests. However, there is a notable discrepancy in the words used in § 188(1) and in § 177(4) (iv), which translates into a significant practical issue. By the words used in the former, it becomes amply clear that while the board approval is required as a condition precedent to entering any such contract, it is not so with the latter. It is unclear whether the clearance for the committee for completing such a transaction is an ex-ante or an ex-post requirement, creating ample confusion. While it can be a safe step to get prior approval, another view is possible that could construe the provision to mean ratification of completed transactions. Citing the obvious difference in the way the two sections have been worded, such a construction is warranted so as to indicate a legislative intent to grant a fair degree of practical flexibility to the companies in getting compliances. This view has not been refuted nor defended. Though the 2017 amendment to § 177(4) (iv) has added some clarity on the matter. It mentions that "Provided also that in case any transaction involving any amount not exceeding

One Crore rupees is entered into by a director or officer of the company without obtaining the approval of the Audit Committee and it is not ratified by the Audit Committee within three months from the date of the transaction, such transaction shall be voidable at the option of the Audit Committee and if the transaction is with the related party to any director or is authorized by any other director, the director concerned shall indemnify the company against any loss incurred by it.” This gives an impression that under the section an approval could be sought either before the contract is entered upon, or post that, by way of ratification within three months. If this interpretation is adopted it would serve the purpose of flexibility in corporate decision making, however, would lead to yet another loophole. Since that would mean that for companies that undertake higher value transactions in the ordinary course of business for instance—an asset management company would now have the option of entering into such contracts with no prior approval at all. However, the section only provides for indemnification of any loss which results from disapproved related party transactions of less than One Crore, which leaves companies undertaking higher value transactions regularly at a potentially greater risk of abuse. The law should perhaps aim to plug such loopholes if this monitoring mechanism is supposed to be equally effective for all companies alike.

The committee is also tasked with evaluating the company’s risk management system. *Risk management system* is a setup, which identifies, analyses, manages and monitors the potential risks associated with a company’s projects and ensures proper measures to mitigate or prevent them are in place. In order for the company to not suffer any major jerk that results in any wealth destruction or even complete shutdown, it is extremely crucial for a robust risk management set-up to be present. This protects the investors directly since destruction of company capital results in direct depletion of their interests in the company.

The audit committee has been allotted the additional responsibility to assess the effectiveness of this system, and to check whether it is of appropriate measure [28]. However, there is absolutely no guideline as to what should be the criteria for such assessment. Though for the listed companies this is essentially taken care of, by Regulation 21 of SEBI (LODR) Regulations, 2015, which mandates the formation of a separate *risk management committee*. Next, another way in which the committee directly commits to protection of investor rights is to ensure that the sums raised through public offers are put to appropriate or indicated use. This restricts any misuse of investor funds by the management, by making it liable to show that the money raised was put to use in the manner so advertised [29].

Another important role that has been assigned to this committee is in the valuation of the company’s assets where necessary; this ascertains that the company does not misrepresent any asset related information to the investors. This directly helps remedy the information asymmetry that exists between insiders and the outsiders, which helps the investors take an informed judgment call on whether to invest at all, and how much.

Last, this committee is also required to oversee the company’s vigil mechanism under § 177(9) and (10) of Companies Act, 2013. The vigil mechanism acts as a forum to receive concerns from all directors and employees, about any kind of inappropriate or unethical behavior cultivating in the company that should raise concern among parties being aggrieved. The committee must also see that that the apparatus is to foolproof, that is, it prevents the victimization of those who seek to use it. This additional role of the Audit Committee “augurs well for preventive action against corporate frauds” [30], which adversely affects all the stakeholders, including investors alike.

The Audit committee under the Indian statute only requires a majority of Independent Directors [31], similar to many other countries like the United States; however, there have been critiques of this approach, who demand for an audit committee comprised completely of independent directors [32]. Constituting a board only with outsiders leaves open the possibility that the decisions might not reflect full information in the pertinent context, however, how much of such insider information really becomes

relevant in the perspective of an audit committee is questionable. In fact, a completely independent audit committee has the potential to be more objective in its approach and decisions than a partial one. In the context of audit committee, the subjectivity that becomes important in the case of nomination and remuneration committee, which requires having a minimum degree of insider knowledge to assess performances, does not in fact matter, and hence, the criticism still remains to be rebutted. Whether an all-independent character would better suit the objective of the committee could be a pertinent question for consideration, since in its functions of valuation of assets of the company for advertisement purposes, or determining the end use of capital amassed, or acting as a grievance resolving forum would arguably benefit more with a body that is unrelated to the company affairs and hence not in a position to favor or disfavor the investors deliberately.

CONCLUDING REMARKS

This article sought to examine the role of board committees in protection of investors in companies. The approach taken was to firstly, sketch out the underlying issues or conflicts that endanger investor rights in a corporation, where the identification and analysis of the conflicts was drawn from the structure of the company itself. The findings suggest that since a company is a complex framework of contracts with an agency structure at heart. This structure inevitably envisages the usual conflicts that arise with such a relationship. The conflicts often pan out in disfavor of the investors, since the management is in a position to leverage its strategically superior knowledge in its own favor at the cost of the company and its investors. This tradeoff between company welfare, and misappropriation by the directors, endangers investor rights. An approach to find a solution to above issue, lies within the corners of corporate governance mechanism embodying the objective of investor protection. The article finds that board committees are an extremely crucial part of this mechanism—being specialized bodies with demarcation of duties, and possessing the necessary independence unlike the Board of directors, to objectively assess and perform their tasks. An analysis on their general roles as defined by the Companies Act, 2013 shows that they seek to resolve many of the agency conflicts that would otherwise exist unchecked, or inefficiently checked, which indicated a better probability of protection of investor rights. However, the analysis also indicates that there are a few grey areas in the provisions of the law, which leave certain loopholes that perhaps restricts the investors from enjoying full benefits of these committees. In other words, individual analysis of the three committees suggests that there exists a possibility of improvement in the provisions of the statute, which would further the purpose of investor protection. Given the recent lapses in auditorial duties seen in startups like *Byjus*'s, the role of board committees in arresting these lapses in timely manner cannot be overstated.

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