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A Study of Investor Protection in the Indian Stock Market: A Comparative Analysis of the Old and New Companies Act

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Abstract:

The protection of investors has been a pressing issue for years more so since the outbreak of the Enron and the Satyam scam in India which has demanded changes in legislations. This paper attempts to analyse the provisions of the new Companies Act in context of investor protection provisions. It is pertinent to point out that the impact to these measures needs to be gauged time and again to keep the laws abreast with changing needs.

1. Introduction

Company form of ownership has been most popular among elite class willing to take up lucrative projects but lacking the adequate financial resources. This form of ownership enables business minded people to mobilise savings from the public and invest in profitable ventures. This process seemed simple to the people tagged as investors who subscribed in the company's capital pre Satyam fraud, a case that alarmed all concerned specially the regulatory authority to initiate steps to protect investor's interest. The manipulations done by the white collar professionals in the accounts of companies have come to light since Enron scandal. Investor confidence in the stock market has shaken with Raju confessing his guilt of falsification of the accounts of Satyam one of the biggest IT companies. Serious concerns in reFrom the Board, Auditors, The objective of stricter regulation was to blow a whistle even before a fraud could be committed by the officers of the Company. Thus this new bill is forward looking aiming at preventing frauds and scams rather triggering a situation when such scams is anticipated. Instances of such fraud have global presence in fact the Satyam scam is tagged as the Indian Enron case. Such frauds by White collar professionals have increased the scope of offences that can be committed by the white collar employees. Interestingly the greed for more has crept into even the professional class calling for enough provision in legislation to shield the investors.

Though the Companies Act, 1956 provided for several provisions to protect the interests of the shareholders, it did not keep pace with the changing business environment.¹ The new companies Act addresses several investor concerns and seeks to provide a more hospitable environment for minority shareholders, especially in the wake of scams and scandals such as the one that hit the Satyam Computer Services in 2008.

2. Literature Review

From Enron, WorldCom to Satyam, it appears that corporate accounting fraud is a major problem that is increasing both in its frequency and severity. (Bhasin 2013) Research evidence has shown that growing number of frauds have undermined the integrity of financial reports, contributed to substantial economic losses, and eroded investors' confidence regarding the usefulness and reliability of financial statements. The increasing rate of white-collar crimes demands stiff penalties, exemplary punishments, and effective enforcement of law with the right spirit. An attempt is made to examine and analyze in-depth the Satyam Computer's "creative-accounting" scandal, which brought to limelight the importance of "ethics and corporate governance" (CG). The fraud committed by the founders of Satyam in 2009, is a testament to the fact that "the science of conduct is swayed in large by human greed, ambition, and hunger for power, money, fame and glory". Unlike Enron, which sank due to "agency" problem, Satyam was brought to its knee due to 'tunnelling' effect. The Satyam scandal highlights the importance of securities laws and CG in 'emerging' markets. Indeed, Satyam fraud "spurred the government of India to tighten the CG norms to prevent recurrence of similar frauds in future". Thus, major financial reporting frauds need to be studied for "lessons-learned" and "strategies-to-follow" to reduce the incidents of such frauds in the future. While the Sarbanes Oxley Act improved corporate governance and decreased the incidents of fraud, recent survey indicated that the investors and management continue to have concerns about the financial statements fraud. It may be emphasised that consequences of such fraud could bewidespread with sometimes devastating ripple effect. Those affected may range from immediate

¹Subramanian Sundaresha, "Investor Protection will get a big boost under the new Company Law", Business Standard, 19-12-2012.

victims (the company's stakeholders and creditors) to the more remote (those harmed when investor confidence in the stock market is shaken). Frauds by while collar professionals need to be regulated through effective laws and responsible management.

3. Hypothesis

The new legislation, The Companies Act 2013 provides new provisions for protection of investors and governance, thus ensuring effective regulation of the company form of organisation. The new provisions have the potential of improving the plight of minority shareholders as well as the majority. The definition of key managerial personnel has further emphasises on the fulfilment of duties and highlighted the importance of responsibility towards the society.

4. Research methodology

Since the research emphasis on throwing light on the new Act which propose to boast investor protection and enhance the governance of companies, this study would focus on the two legislations i.e. The Companies Act, 1956 and Companies Act, 2013 accompanied with analysis of relevant cases highlighting the need of investor protection. The study would include a mix of primary and secondary sources so as to analyse the 2013 Act in comparison to 1956 Act. Since the new Act would be operational from April 2014, this analysis would be supplemented by relevant reports, discussions and news. The paper discusses legislative provisions which boost the protection of investors.

5. Study and Results

5.1. Legislation

The new Act² has incorporated provisions in relation to Governance, Justice Delivery Mechanism, Key Managerial Personnel and investigations that propose to strengthen the interest of investors. Since a company is not a natural person, it is the managerial personnel who head the company to a particular direction making it imperative to recognise who this personnel would be to make them more accountable as well as responsible which was absent in the 1956 Act. Thus the 2013 Act defines the key managerial personnel (KMP)³ so as to expressly identify them with the aim of introducing a code of responsibility and accountability in them. For instance, the attachment of the Director Responsibility Statement⁴ to the financial reports of the company stating the upkeep of the accounts according to accepted standards and on a going concern basis, compliance with policies and laws and incorporation of internal control system. The requisition of additional disclosures to be made in the Board's report in relation to the number of Board meetings, appointment and qualification of Directors, loans, advances, investments, state of Company affairs go further in strengthening the transparency in management. The Act goes a step further to incorporate duties of director to ensure diligence in their work which found no place in 1956 Act. Three new categories of directors, namely Independent, Women and Resident are provided for aiming at a fair process of director selection. Multiplicity of reports and disclosures by personnel at different levels ensures informed investment decisions by the investors. In order to bring laws in line with the advancement in technology the Act mandates the maintenance of accounts in an electronic format, encouraging e-governance⁵ and thereby facilitating easy inspection of such accounts. The insistence of participation of Directors in Board meeting pushes the involvement and responsibility of Directors towards the Company recognizing also an audio visual participation⁶ which may be recorded and stored for further reference. Non participation of Directors in the past accelerated the need for a legislation that could invoke an active involvement and participation of this elite class of directors in order to further the interest of the company. At the same time it is pertinent to mention that while investors do step forward to complain against the frauds committed by key personnel, but none took an interest in voting on key managerial issues. In order to ensure investor members' participation an option of electronic voting⁷ is provided to encourage active involvement in key issues of management. The Act is instrumental in insisting participation of members and directors in Company affairs by liberalizing the physical presence in meetings and providing for a vote through electronic mode and postal ballot. The 2013 Act has incorporated the provision of rotation of auditors so as to ensure fair dealings and reduce their coalition with key personnel in frauds and mismanagement. In fact before an auditor resigns from any company it has become mandatory for him to state reasons for quitting the assignment.

The interest of minority shareholders has been secured by providing for one director for small shareholder and an exit option to the minority shareholders anytime.

² Companies Act, 2013

³ Section 2 (51) Key Managerial Personnel (KMP), in relation to a company, means-

(i) the Chief Executive Officer or the Managing Director or the Manager,

(ii) the Company Secretary;

(iii) the whole-time director;

(iv) the Chief Financial Officer; and

(v) such other officer as may be prescribed

⁴ Section 134(5) of the Companies Act 2013.

⁵ Section 120

⁶ Section 173(2)

⁷ Section 108

Satyam scam was a landmark case which prompted the framers of the legislation to reform the justice delivery system and incorporate the concept of class action suits so as to ensure that a class action can be bought by the aggrieved shareholders. Serious Penalties have been introduced for insider trading, forward dealing, and tampering with minutes to deter the personnel indulging in such activities by imposing fines. Clearly the intention of the legislation draws our attention to the fact that only fair and transparent dealing have place in commercial world. In order to further this objective the Act provides for a vigil mechanism and investigative officer for serious frauds. Serious investigation fraud officers (SIFO) have the power to make arrest and the investigation report framing charges shall be treated as report filled by police officer. For this purpose unlike 1956 Act, the 2013 Act defines fraud and imposes a penalty including imprisonment and fine. The National company law tribunal is entrusted with the task of overseeing the restructuring process and even special courts are provided to enhance the justice delivery mechanism. In addition, a panel of experts called as Mediation and Conciliation shall be maintained by the Central Government for mediation between the parties during pendency of proceedings before the Central Government or Tribunal.

The new Act permits cross- border mergers and makes adequate provisions for companies to comply so that interest of all is ensured.

5.2. Challenges Ahead

The Companies Bill, 2012 can be applauded for being a detailed legislation clarifying provisions extensively. At the same time there are certain challenges which need to be addressed and answered before it becomes operational.

First, the director's provision permitting holding of 20 directorships creates a mockery of the legislation as the legislators seem to turn blind to the facts that burden of twenty directorships would indeed not extend protection to investors. Facts suggest that directors in past have been habitually absented in various company meetings. Analjit Singh of Max India, for example, attended only one out of 14 board meeting of Dabur in three years, before he resigned. The question logically is how he has assisted in protecting the interest of investors.⁸ Moreover bureaucratic monitoring of the Directors through director identification number (DIN) is questionable as it has led to corruption and bribery considering India's track record. Appointment of independent director has gathered mixed response for if promoters are to appoint independent a director how is independence to be ensured. In an urge to ensure gender diversity the parliament has provided for Women directors but availability of women is a question. According to GMI Ratings' Women on Boards Survey 2013, even on the world's best-known companies, women account for only 11 percent of total directorships. In India, a sample of 89 companies with more than \$1 billion in market valuation, the women percentage is less than 7 percent.

Perhaps the best new provision in the Companies Bill is the enabling of tort action and class action suits. If this provision had been on the statute book in 2008, Satyam's Indian shareholders could have filed a class action suit against the Rajus, or even the Mahindra-run company that took over Satyam's assets. Mahindra Satyam settled lawsuits in the US and UK since these countries enable class action suits, but in India shareholders were left twiddling their thumbs while foreign shareholders were paid off. This can't happen in future, but the moot point is whether shareholders of government-owned companies can sue the government for squashing minority interests. It is worth recalling the Coal India has been sued by a minority shareholder (The Children's Investment Fund) for following the government's diktat to lower coal prices in 2012. There is ample scope for class action suits against ONGC, Oil India and GAIL, which are subsidizing losses in the oil marketing companies. Class action suits have to be filed before the National Company Law Tribunal first, but banking companies are excluded from such action. In the weeks ahead, as companies pore over the fine print of the Companies Bill, more issues will surface. But for now the best sum-up is this: it's a great start, but, as always, the proof of the pudding is in the eating.

6. Conclusion

The new Act definitely holds a promise to fulfil the gaps in providing protection to investors, but at the same time it is faced with challenges. Indian investors have high hope with this Act in the context with their protection which would be reflected in the share bazaar. Retention of the confidence of the investors in the company would restore the so called lost hope and aspiration of the investors in context with investment in companies. Small incorporations in law such as class action, National company law tribunal, serious fraud investigation officer, governance, if judiciously implemented would go a long way in bridging the gap between the interest of investor and key personnel. Though the Act comes in force only in 2014 the consultative process is in progress so as to ensure general public specially investors to provides valuable inputs to enhance the provisions of this new Act to make it a success. Consultative process is an urge to all investors to put forth valuable questions and assist in framing of the Act.

7. References

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