Ethical Governance in Capital Market

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ABSTRACT

Ethics refers to the moral principles which guide the right conduct of individuals and organizations. The ethical issues in accounting and finance have a significant impact on our financial well being. People will participate in capital markets only if they perceive the markets to be fair and equitable. Unethical behaviour on the part of individuals and organizations can rob people of their life savings. Therefore, corporate governance is considered as a priority on SEBI's agenda, to ensure transparency and accountability to be provided to the investors, collaborators and buyers. This paper presents the corporate governance scenario in India and the investigations taken up in the capital market during 2009-10 and 2010-11.

Keywords

Governance, Ethics, Mechanism, Transparency, Capital Market

Introduction

Governance is the process whereby people in power make decisions that create, destroy or maintain social systems, structures and processes. So as 'Corporate Governance' refers to the way a company is run, therefore it is the process whereby people in power direct, monitor and lead corporations, and thereby either create, modify or destroy the structures and systems under which they operate. Corporate governors are both potential agents for change and also guardians of existing ways of working. As such, they are therefore a significant part of the fabric of our society.

The concept of corporate governance is to some extent similar to the quality practices adopted under the ISO standard. It includes defining of the powers of Directors, particularly non-executive ones, making available information on the Company's current state of affairs to all the Directors, and systems control to ensure the authenticity, timeliness and effectiveness of the information. According to the Kumar Mangalam Birla Committee, the fundamental objective of corporate governance is the "enhancement of long-term shareholder value while, at the same time, protecting the interests of other stakeholders."

Objective

- To know the mechanism and drawbacks of corporate governance in India.
- To know the current corporate governance scenario in the Indian Capital Market.

Mechanisms for Corporate Governance

Corporate governance is an ongoing process. And its mechanisms are designed to reduce the inefficiencies that arise from moral hazard and adverse selection among the clashes of different interests of the Owner or the Manager or the Accountant. The mechanisms of corporate governance can be classified into two ways - (a) Internal and (b) External.

Internal Corporate Governance Mechanism

Internal corporate governance mechanisms monitor activities and then take corrective actions to accomplish organizational goals. The corporate boards, managers, shareholders and employees within the corporation decide how companies are directed and controlled. The boards oversee the running of a company by its managers, and in turn the board members are accountable to shareholders and the company. The board is expected to ensure that the management complies with the legal and ethical standards.

External Corporate Governance Mechanism

External corporate governance mechanism includes the control external stakeholders like the government, investors, financial institutions and customers exercise over the organization. For example, Government as the regulator sets the legal, financial and business framework which defines the scope and extent of corporate governance.

Impact of Corporate Governance

Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is, therefore, to encourage the efficient use of resources and equally to require accountability and disclosure of managing those resources. Such transparency in the organizational functions will result into good corporate governance and poor corporate governance.

Good Corporate Governance

Openness is the basis of public confidence in the corporate system, and funds will flow to the centers of economic activities that inspire trust. The incentive to corporations is that these corporate governance standards will help them to achieve their corporate aims. While the incentive for their adoption by States is that it will strengthen the economy and discourage fraud and mismanagement.

Good corporate governance plays a vital role in strengthening the integrity and efficiency of financial markets. The adequacy and the quality of corporate governance shape the growth and future of the capital market. It helps to protect the interests of shareholders and all other stakeholders, and contributes to the efficiency of a business enterprise, to the creation of wealth by attracting investors. More and more people are recognizing that corporate governance is indispensable to effective market discipline. Studies of firms in India and abroad have shown that markets and investors take notice of well managed companies, respond positively to them, and reward such companies, with higher valuations.

Another important aspect of corporate governance relate to the issues of insider trading. It is important that insiders should not use their position of knowledge and access to inside information about the company, and take unfair advantage of the resulting information asymmetry. To prevent this from happening, Corporates are expected to disseminate the material price sensitive information in a timely and proper manner and also ensure that till such information is made public, insiders abstain from transacting in the securities of the company. This, therefore, calls for the companies to devise an internal procedure for adequate and timely disclosures, reporting requirements, confidentiality norms, code of conduct and specific rules for the conduct of its Directors and employees and other insiders. However, the need for such procedures, reporting requirements and rules also goes beyond Corporates to other entities in the financial markets such as Stock Exchanges, Intermediaries, Financial Institutions, Mutual Funds and concerned Professionals who may have access to inside information.

In India, there are some of the companies like Infosys, Wipro, and HUL etc., which act as a benchmark for the successful corporate governance. Their corporate governance practices offered many lessons to corporate India. And they have shown that increasing shareholder wealth and safeguarding the interests of other stakeholders is not incompatible.

Poor Corporate Governance

Poor corporate governance weakens a company's potential and at worst can pave the way for financial difficulties and even fraud. It also has negative implications on the economic stability and development of the country. The financial crisis in emerging markets has led to the renewed discussions and inevitably focused them on the lack of corporate as well as governmental insight.

Governance in Capital Market

Corporate governance is considered as an important instrument of investors' protection, and it is therefore a priority on SEBI's agenda. SEBI has been constantly working towards improving the level of corporate governance in the country and in view of the stage of development of the capital market, SEBI considers it imperative that the adoption of globally acceptable practices of corporate governance be accelerated in India. This would ensure that the Indian investors are in no way less informed and protected as compared to their counterparts in the best-developed capital markets and economies of the world.

Timely completion of investigation cases and effective, proportionate and dissuasive action in case of violations of established securities laws is important for the protection of investor's interest, ensuring fair, transparent and orderly functioning of the market. It is also vital for improving the confidence in the integrity of the securities market.

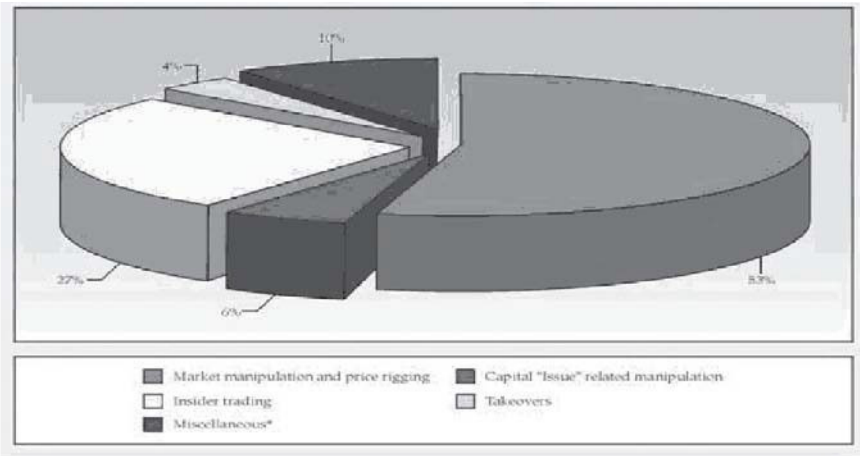
Keeping these objectives and principles of securities regulations in view, SEBI initiates investigation to examine alleged or suspected violations of laws and obligations relating to securities market. The possible violations may include price manipulation, creation of artificial market, insider trading, capital issue related irregularities, takeover related violations, manipulation of financial results, non-compliance of disclosure requirements and any other misconduct in the securities markets. The details of investigation cases taken up and completed are provided in Table 1:

Table-1: Nature of Investigations Taken Up and Completed

Particulars	Investigations Taken up		Investigations Completed	
	2009-10	2010-11	2009-10	2010-11
Market Manipulation and Price Rigging	44	56	46	51
Capital "Issue" related Manipulation	2	6	7	2
Insider Trading	10	28	10	15
Takeovers	2	4	5	4
Miscellaneous	13	10	6	10
Total	71	104	74	82

Source: SEBI Report 2010-11

Figure-1: Nature of Investigation Cases (2010-11)



Source: SEBI Report 2010-11

During the year 2010-11, 56 cases out of 104, i.e. about 53 percent of the cases taken up for investigation pertain to market manipulation and price rigging, as against 44 cases out of 71, i.e. about 62 percent of such cases in the previous year. Other cases pertain to insider trading, takeover violations, irregularities in capital issues, and other irregularities.

Thus Table 1 shows that the highest cases completed in both the current as well as previous year were pertaining to market manipulation and price rigging i.e. about 62 percent. Followed by the other cases in which investigation was completed pertain to capital issue related manipulation, insider trading, takeovers etc. Figure 1 also shows the graphical presentation of the nature of investigation cases taken up in the year 2010-11 by SEBI.

Miscellaneous cases include investigations pertaining to fraudulent transfer of shares by promoters to their own accounts; dematerialization / offloading of locked in shares; suspected trading by market participants such as technical analysts; unregistered portfolio managers; corporate governance irregularities; listing agreement irregularities; transfer of trades; manipulation of financial results, etc.

Drawbacks of Corporate Governance in India

The biggest corporate scam in India has come from one of the most renowned software company, Satyam Computer Services. This fraud was being equated with Enron scam of USA. And it disclosed the inherent weaknesses of Corporate Governance in India. Satyam's founder Ramalinga Raju cooked up the account books and inflated the figure by Rupees 5040 crores. He committed this fraud and tried to suppress it by an abortive bid to purchase Maytas infra, a company created by him. Raju started diverting the cash from Satyam into Maytas and many other companies which he had formed either in his own name or benami like Godavari bio, Godavari agro etc.

Satyam has bagged Golden Peacock award for best corporate governance by World Council for Corporate Governance only a few years ago of this scam. The scam has raised many doubts about the class of corporate governance in India. In fact, such practices are very common and prevalent in many Indian companies. And it is required that some concrete steps with respect to it should be done.

There are few important elements of corporate governance namely Auditing, Independent Directors, Regulators and finally the Board including CEO itself. If we examine these constituents one by one, it would be crystal clear that all the constituents either failed or did not act as was required.

First, the Auditing firms outsource unqualified or semi-qualified candidates to do the auditing in the companies. The prestigious firms get the assignment by virtue of their name and fame which they recklessly sell in the market by outsourcing the auditors at a very low remuneration, and these auditors approve their accounts easily. Auditors have the vast statutory powers but without any responsibilities. This needs to be changed.

Second, the Independent Directors have also failed to discharge their duties properly. Section 49 of SEBI Act and section 229 A of Company Act, 1956 provides for appointment of Independent Directors in the Companies for protecting the rights of public at large in general and shareholders in particular. These Independent Directors would dare to look into the affairs of the company against the wishes of the CEOs.

Third, the SEBI and Ministry of Company Affairs too have failed in their assigned jobs. SEBI is the highest regulator and keeps an eagle eye on the activities of the capital markets. There has been a lot of hue and cry with respect to insider trading; and SEBI failed to listen to and it inflicted heavily on Satyam.

Fourth, it is assumed that the State Government and the Banks somehow were also involved in the scam. The continuous inflating and cooking of accounts, that too on such a big scale was going unnoticed and unchecked by the auditors and the Bankers sounds absurd.

Loosing Ethics in Corporate Governance

Ethics refers to the moral principles which guide the conduct of individuals and organizations. It is related with the principles of right conduct. Some Scholars remark that there is no ethics in finance. But in reality finance would be impossible without ethics. Accounting and Finance Professionals handle assets of others and, therefore, enjoy their immense trust. As agents of their clients, these professionals are under obligation to protect and promote the interests of clients. People will participate in capital markets only if they perceive the markets to be fair and equitable. Authorities regulate capital markets to ensure fairness and to protect the interests of investors and the public. The purpose of regulation is to prevent fraudulent and manipulative practices in capital markets. Ethical issues in accounting and finance have significant impact on our financial well being. Unethical behaviour on the part of individuals and organizations can rob people of their life savings.

But mostly business firms, now a days are having the only motive to earn more and more profit, so they tend to move towards the unethical activities. And to perform these activities they also get the support from the Audit Committees, Regulators, Ministries and even Banks. The question arises here, 'Is earning profit or money the only motive of the business firms and professionals? Are they not aware of their responsibilities towards public? And if the regulators will also involve in this gamut then who will take the responsibility to control these wrong things?'

Conclusion

The paper outlined the impact of ethical corporate governance in the capital market. The Satyam fraud was neither the first nor will it be the last corporate scam to have hit India, so investors must be on guard and ask for more information before making any investment decision. It is required that SEBI come out with a series of new guidelines for the listed companies. Strict vigil is sought to be kept to check insider trading.

There is a need to examine the loopholes in regulation, accounting, audit and governance that allowed such lapses to occur and address them with urgency as this has shaken the confidence of investors, both domestic and global.

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