# The Significance of a new Companies Bill

Apart from introducing India-relevant features, the Companies Bill 2011 also seeks to set in place regulations to effectively prevent the incidence of corporate fraud and mismanagement while stringently monitoring auditors

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**How is the new Companies Bill, 2011 different from the Companies Act, 1956 with its large number of amendments over the years?**

The Indian business landscape has changed significantly since 1956 with the economy more globalised, capital more fungible, lower government supervision of businesses and society getting more vigilant towards their rights and entitlements.

Laws need to reflect societal and economic changes and not merely drafted to mitigate events and scams that have happened in the recent past. By amending Clause 49 of the listing agreement, SEBI brought in new rules of corporate governance, which was drafted in lines with Sarbanes Oxley Act or SOX. SOX was a enacted in USA to counter the gaps exploited by companies and other intermediaries of capital markets in the scams of Enron, WorldCom etc., and was defined to meet the challenges of the US society and markets.

By bringing in laws that are almost replicas of those operating in developed markets, we cannot materially enhance the quality of corporate governance in India, where most of the listed companies have a significant majority holding by the promoter group while in the west such laws are written for companies having dispersed shareholdings.

The Companies Bill has brought in elements of laws that work well in other markets such as accepting the changes related to the digital age by allowing use of video conference for board meetings, electronic voting in general meetings and electronic filings, shelf registrations, exit options for minority shareholders, etc. as well as a few elements that make it contextual for India.

The new bill has consolidated many sections of the previous act and appears to be relatively lean, with 470 clauses and 7 schedules as against 658 Sections and 15 schedules in the existing Companies Act, 1956. The fundamental premise of this Bill is to present a law that is modern and relevant while incorporating global best practices and balancing the complexities and realities of operating in India. The Bill is particularly powerful in the areas of oversight, protection of minority shareholders, management and business conduct and overall governance.

**Will the new proposals in the Bill protect the society better than the previous Act?**

This new bill includes many provisions which recognises the changing times and includes affirmative actions for protection of small investors, defining revised roles of directors to make them more effective and accountable, enhancing responsibilities of auditors as gatekeepers and laying down provisions that include severe punishment for fraud, false evidence or known misconduct for every person who has a duty of trust towards a company.

Economists argue that having no law is better than having laws that cannot be enforced. Indian system was plagued by a delayed system of enforcement. This bill envisages a quick redressal mechanism by constituting Tribunals, special courts and even the High Courts delegating some of their responsibilities to lower courts for a quicker delivery of justice.

However, the success of proposed bill with enhanced protection to society is largely dependent upon on the quality of implementation irrespective of how good the intent of legislature is in its design and objectives.

**How will the Bill improve corporate governance? Will the independent director's role now be effective?**

There are significant changes in the roles, independence, appointment, rotation, evaluation and responsibilities of independent directors and code of conduct by other directors. The current bill requires that all resolutions in a meeting convened with a shorter notice should be ratified by at least one independent director. This could create an element of veto power by these directors, which will be unique to India. The other clauses on directors' responsibility statements, statement of social responsibilities, and the directors' responsibility over financial controls, fraud, etc. will create a more transparent system brought about through better disclosures. The bill also proposes inherent principles of anti-self-dealing where by any undue gain made by a director by abusing his position will be disgorged and returned together with monetary fines.

The additional provisions and proposals that foster corporate governance include regulating related party transactions , consolidation of all companies within the group, self -declaration of interests by directors along with disclosures of loans, investment & guarantees given for the businesses of subsidiary and associate companies, which may be outside of normal disclosures.



The bill proposes an enhanced investor protection framework by bringing in proposals for class-action suits, empowering small shareholders who can restrain management from actions which they believe are detrimental to their interest or circumstances when such shareholders can exercise an option of exiting the company where they do not concur with proposals of majority shareholders. The new bill also proposes tighter norms for raising money from the public and makes insider trading, impersonation etc. a criminal offence. These norms in isolation do not make a paradigm shift but when aggregated, these changes are structural and fundamental

However, in the quest for creating an environment of independence, laws can become restrictive for an enterprise. The case in point is the clause that requires that companies need to select independent directors from a database maintained by the government or explain why they have not used such a database. A board is a unit of management and oversight of an enterprise, whose primary objective is to maximise returns for its shareholders. In such a case, having independent directors, who may have significant dissimilar views on running of a company could create significant barriers to decision making especially when they collectively could exercise veto powers. Jury is still out whether having activist individuals on a board creates better value for the minority shareholders.

**Will the role of auditors as gatekeepers change and will that improve audit quality?**

Recent financial frauds have sullied the image of Indian corporate environment and to restore confidence in legal framework governing Indian corporates and capital market, this bill has proposed radical revision in the roles of gatekeepers.

Statutory auditors now have onerous duties and responsibilities as whistle-blowers to formally report any fraudulent acts of the management. They are subject to compulsory rotation and are expected to adhere to strict independence standards. They hold their position in fiduciary capacity, are subject to periodic rotation and this bill has proposed restrictions on accepting non-audit jobs. In case of failure to act diligently or in case of fraud, the proposed law prescribes civil, criminal and monetary fines, in proportion to the quantum of fraud that is later detected.

The issues relating to rotation of auditors have been debated at length though whether such rotation improves audit quality and independence is an open question and there is no empirical evidence that conclusively proves either point of view. The government companies have been compulsorily rotating their auditors every few years for the last 50 years but whether that has led to improved audit quality has not yet been established. Similarly, a common link for a number of corporate failures across the world has been a long standing cosy auditor - client relationship.

The oversight mechanism apart from the audit committee will also include a statutory body, National Financial Regulatory Authority, with powers of a civil court empowered to notify accounting and auditing standards and monitor compliance of such standards including regulating the professionals, who are required to comply with them. Serious Fraud Investigations Office (SFIO), will be another agency enforcing governance with statutory powers to prosecute. The oversight framework for auditors is now moving away from principles of self-regulation of the Indian Institute of Chartered Accountants to a government body with powers of a court .This change may alter the way the accounting profession in India is carried out.

**Should contribution towards Corporate Social Responsibility (CSR) need to be mandated?**

Indian companies usually do not differentiate between CSR and corporate philanthropy and hence no distinction is made between a strategic spend and donations. A compulsory spend of 2% of profits by companies of certain size for causes approved by the government also works against shareholders rights and entitlements as this spending is not aligned to the company’s strategy and hence not sustainable.
The freedom of choice to determine how much and the manner to spend on CSR should be left to the company .From the point of the beneficiaries, how they get affected in the year of a loss or low profits, is a matter of concern as the investments of earlier years may be lost if funding is not sustained over the life of a project.

**What are the areas that Indian companies will find challenging?**

The Bill will have a significant effect on the amount of loans a company can take or give guarantees in case of a loan by another subsidiary for acquisition or other purposes, which will impede the ability of leveraging the balance sheet. The new provisions stating that acquisitions by Indian companies overseas will not be allowed to be layered beyond two entities may affect complex and structured transactions.

Following the learning from some of the recent scandals, the Bill seeks to prohibit making contributions to trusts that are not for bona fide reasons and also needs unqualified approvals of the Board and public financial institutions to give large loans to affiliates etc. These measures seek to fill in some gaps that were exploited by companies in the past.

Smaller companies will be hurt by having to follow the process and compliance in relation to raising funds through the private placement process making equity capital very expensive.

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