PREVENTION AND CONTROL OF CORPORATE FRAUDS: A SOCIO-LEGAL STUDY OF FINANCIAL MARKET IN INDIA

ABSTRACT

Today everyone is talking about good corporate Governance. No one in corporate world will deny its existence. Good corporate governance ensures transparency and accountability and ensures effective investment in corporate world. This topic was not in vocabulary a few years ago. Governance implies a degree of control to be exercised by every stakeholder representative. Governance is merely governing. It is not merely ownership. Even an owner has to govern. Good governance implies that the institution is run for the optimal benefit of stakeholder in it. It attempts to remove corporate failures and dissatisfaction of its stakeholders. In the modern era of liberalization and globalization, corporate governance plays an important role. Since reliance on corporate sector has increased, it led to greater concern on how corporations operate and control and how supplies of fund are assured of fair return on their investments. Corporate governance aims to achieve balance between all interests present in corporations: management, shareholders and other stakeholders. The corporate governance frameworks ensure that timely and accurate disclosure is made on all material matter regarding the corporation, including the financial situation, performance and ownership. It ensure that corporate managers run their successfully and take care of long term interests of their stakeholders. It improves capital efficiency of companies and attempt to deploy their wealth in productive areas of economy.

As ownership of a company is distributed amongst a large number of shareholders. Majority of who hold a small percentage of company’s capital, the company is managed by the elected board of directors and the chairperson who, with the help of managers and employees of firm look after interests of the company stakeholders. The top level managers have the prime responsibility to use organization’s resource with commitment and dedication to ensure organizational success.

The word corporate Governance is not just Corporate Management. It is something much broader to include a fair, efficient, accountable, transparent
administration to meet certain well defined, objectives. It is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers, and complying with the legal and regulatory requirements, apart from meeting environmental and local needs. It includes the law governing the formation of firms, the structure of firms. The corporate governance structure defines the rights, responsibility of three groups of participants – The Board of directors, managers and shareholders. Corporate governance lays down the rules and procedure for making decision on corporate affairs. It also provides the structure through which the company objectives are set. The fundamental object of corporate governance is to ensure the conditions whereby a company directors and management act in Interests of the firm and its shareholders, and to ensure the means by which managers are held accountable to capital providers for the use of assets. Whereas corporate management deals with the management (Planning, organizing, etc) of corporate enterprises with in a framework of its governance. It deals with the use of corporate resources so that maximum value addition is made to corporate wealth within broad parameters defined in corporate governance.

Corporate governance is about commitment to values and about ethical business conduct. It is about how an organization is managed. It includes its corporate and other structures, its culture, policies and the manner in which it deals with various shareholders. Therefore timely and accurate disclosing the of information regarding financial situation, performance, ownership and governance of company is an important part of corporate governance.

Well functioning financial market is essential part of any modern healthy economy. It is through this market that funds are offered by the lender, saver who have excess funds and purchased by the borrowers/ spenders who need those fund. Financial market in India consists of money market, Government securities, capital market, insurance market, and the foreign exchange Market. Recently derivative markets have also emerged. It is only through financial market that various

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1. Prof Dr Dharmesh Shah, “Corporate Governance: Transparency & Disclosure”
2. “Dr Neeru Vasishth and Dr Namita Rajput”, Taxmann’s corporate governance values and ethics with case studies, January 2010, p-4.
3. Ibid.
4. Ibid.
companies raises finance by issuance of shares, debentures. Public company issue prospectus for raising finance, whereas private companies cannot raise the finance from public. Even government, when it wants to raise long term finance it will often sell bonds to the capital markets. Capital market can be distinguished from money market. Though both are the part of financial market. However The money market are used for the raising of short term finance, sometimes for loans that are expected to be paid back as early as overnight whereas the capital markets are used for the raising of long term finance, such as the purchase of shares, or for loans that are not expected to be fully paid back for at least a year. Funds borrowed from the money markets are typically used for general operating expenses. When a company borrows from the primary capital markets, often the purpose is to invest in additional physical capital goods, which will be used to help increase its income. It can take many months or years before the investment generates sufficient return to pay back its cost, and hence the finance is long term.

Till the early 1990s most of financial markets were characterized by controls over the pricing of financial assets restrictions on flows or transactions, barrier to entry, low liquidity and high transaction costs. These characteristics came in way of development of markets and allocative efficiently of resources channeled through them. From 1991 onwards, financial market reforms have been emphasized the strengthening of the price discovery process easing restrictions on transactions, reducing transaction costs and enhancing systematic liquidity.

Moreover the Recognition of issues relating to good corporate governance is due to various frauds in market i.e Harshad Mehta fraud, Satyam fraud, Sahara estate corp fraud and Sharda Chit Fraud Fund etc. Every Year There is new fraud in corporate world. More importantly India is in top list of fraud. These frauds expose the loopholes in regulatory system and need to impose stringent penalty on defaulters. The fraud in Market affects not only the company’s reputation, the investor’s interest but also the development of country as if there will be scam then the common people would not invest in a company and hence there will be shortage of finance which in turn will affect development of the country. Like other countries India has also enacted various legislations and established various authorities to

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6 Ibid.
regulate the market and protect the interest of investors. This legislation will also ensure the accountability of Board of Directors, bring transparency. But despite of a lot of legislation fraud are rampant in India.

The shareholders of the company are vested with the power of 'hire and fire' of the Board of directors. This is so, to make the Board accountable to the shareholders of the company. In this regard, the general meeting of the company is considered as an important event where the individual shareholders discuss the way in which the company is being managed by the board. However, due to various factors shareholders do not utilize the forum of annual and other general meetings for majority of members do not attend the general meetings. Even those who attend are generally passive observers rather than active participants. The prime reason for the passivism is that shareholders have insufficient knowledge, information about the nature and impact of the decision taken by the management. Moreover, they have no incentive to participate in the operations or policy matter of the company.

Moreover, Individual shareholders in large companies hold a very small portion of shares they are not interested in the business operation or in the long-term goals of the company but are rather interested in the maximization of their profits through either selling their shares or receiving dividends. Generally, they are not associated with any policy or decision making process of the company. They consider that due to small shareholding their votes would probably not count in anyway.

Therefore, one of the most significant features of the large public companies of the modern era is the attitude of passivism and non participation by shareholders in the management of the corporation. The non participation of shareholders in operational or policy matters of large companies is very costly due to their dispersed nature of ownership. Moreover, they lack in information, experience, skill and incentives in making sound business decision in the interest of the corporation. They have power to approve or disprove very limited decisions of the board and the real power is vested in the members of the board of directors in respect of important decision making. This resulted into the

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7 Giles Proctor and Lilian Miles, "Corporate governance", Cavendish publishing limited, 2002.
8 In large corporations there is a dispersed shareholding pattern because these corporations require a large capital investment. It is not possible for a single or a handful of individuals to provide such a large amount of investment. Moreover, even such a wealthy individual would not invest his entire amount, as any prudent person would diversify his investment in several firms to mitigate risk. This has lead to dispersed shareholding in the large corporations.
establishment of a central body for the purpose of transmission of all such information, which could help in the decision-making process of the corporation\(^9\). For this purpose, shareholders irrevocably delegate decision making authority to some smaller group for the smooth running of the corporation. It leads to a principal-agent relationship and the board of director is obliged to act in the interest of shareholders and has a duty to maximize the shareholder's wealth.

Now the question arises when there are so many legislation to prevent corporate fraud then what are the loopholes in existing laws? Despite establishment of various authorities like SEBI, Company law Board and by enactment of various law like Companies Act and by introducing various amendments various scandals has been committed which affect the whole society especially the investor. The spate of recent scandals reveals involvement of all the players. The Board fingers Management, Management blames the auditor and the auditor blame the rules. They all pass the buck on other making it difficult to fix accountability. Corporate India will never be the same again. What transpired in Satyam computers in culminating into the historic confession letter of former chairman B. Ramalinga Raju, admitting a fraud of Rs 78 billion has caused the regulators and the investors everywhere to re-examine the corporate governance standards. The multibillion dollar scam is unprecedented and idiosyncratic for more than one reason. The fact that company which was audited by one of the most prestigious audit firms and adopted most advanced accounting and transparent IFRS accounting systems much ahead of time can penetrate such a colossal and a global fraud is clearly eye opening for corporate counsel worldwide. It was triggered with Satyam’s bid to acquire Maytas companies for US$ 1.6 billion\(^10\).This revealed the self aggrandizing policies of the promoters, which caused severe investor backlash.

While there are adequate levels of checks and balances in the system to prevent frauds, it is the slack attitude of each institution responsible for upholding corporate governance that made such a fraud possible. Unless heavy fines and strict liabilities are provided for, if not in the statute then in the internal code of conduct, each of these institutions, namely the internal audit committee, the independent


\(^{10}\) www.economictimes.indiatimes.com
directors and the external auditors could continue to remain “rubber stamps” approbating all management actions. The Satyam scandal has reiterated the importance of checks on related party transactions. Stringent checks and balances on these ought to be incorporated into the Indian corporate and securities laws to prevent transactions like Maytas in future. Pending statutory incorporation, companies can incorporate adequate checks and balances in their code of conduct as a measure of ensuring good corporate governance. It is natural to expect an enhanced level of security of the financial and governance aspects of Indian companies, and to a lesser extent, any Asian-based companies. The role of corporate counsel will assume added pressures, with a higher emphasis on preventing frauds.

In the area of securities regulation, SEBI has made numerous changes in recent years including: revising and strengthening Clause 49 in relation to independent directors and audit committees; revising Clause 41 of the Listing Agreement on interim and annual financial results; and amending other listing rules to protect the interests of minority shareholders, for example in mergers and acquisitions. SEBI brought out new rules in 2009 requiring greater disclosure by promoters (i.e., controlling shareholders) of their shareholdings and any pledging of shares to third parties. And in November 2009 it announced it would be making some further changes to the Listing Agreement, including requiring listed companies to produce half yearly balance sheets. More recently, in December 2009, the Ministry of Corporate Affairs (MCA) published a new set of “Corporate Governance Voluntary Guidelines 2009”, designed to encourage companies to adopt better practices in the running of boards and board committees, the appointment and rotation of external auditors, and creating a whistle blowing mechanism\(^\text{11}\).

In the current corporate governance practices it is required to focus on particular corporate governance mechanisms. There are two types of mechanism that resolve the conflicts among different corporate claim-holders, especially, the conflicts between owners and managers, and those between controlling shareholders and minority shareholders. The first type consists of various internal variables, e.g. (1) the ownership structure, (2) board of directors (3) executive compensation and

\(^{11}\) \url{www.mca.gov.in} visited on 27\textsuperscript{th} Sept 2013.
(4) financial disclosure. The second includes external mechanism with variables, e.g. (1) effective takeover market, (2) legal infrastructure and (3) product market competition. “Good corporate governance practices are a sine qua non for sustainable business that aims at generating long term value to all its shareholders and other stakeholders”\(^\text{12}\).

A more comprehensive review of corporate governance regulation and practices is required in India. While the new “Voluntary Guidelines 2009” provide helpful and detailed guidance to companies interested in developing a more effective board of directors yet lot of issues remain unattained and unanswered. Nor will the new Companies Act resolve these challenges.

Nomination committee can be advisably established comprising solely of independent directors or a majority of independent directors empowered to appoint the board and evaluate its performance. Although evaluation of performance is not yet mandatory under the extent of corporate governance regime yet it might yield a better result and in further course of time it should be made compulsory\(^\text{13}\).

**Aims and Objectives of the Study**

It is said that identifying a problem is what gives us energy and focus to solve them as every problem has it the seeds of its own solution. The Statement specifies the need of defining the objective of this research. The objective of this research is to touch significant issues relating to corporate governance. The study focuses on the various legislation dealing with the corporate world. Other objective of this study is-

1. To analyse existing law dealing with corporate governance and their implementation.
2. To Highlight the Report of various committee for Good Governance
3. Study of Case law relating to Corporate fraud and reason behind those Fraud
4. Role of Existing Regulatory Authority for preventing corporate fraud
5. What are the effect of corporate fraud on the society

\(^{12}\) Corporate Governance Voluntary guidelines, 2009
\(^{13}\) Akshat Sulalit, “Companies Act, 2013: Rise of the Minority Shareholder” available on www.indialawjournal visited on 17\(^{th}\) April 2012.
6. To point to possible options for resolving these problems and what is way forward for each issue.

**Research Methodology**

The methodology of research differs according to the subject. The study is doctrinal in nature. The relevant material is collected from primary and secondary sources. Material and information are collected from various National Enactments, Legal and other sources like published works, Law journals, national journals and websites on relevant topics. An attempt is made to analyse the existing law dealing with corporate world and to highlight the loopholes in existing System.

**Chapters Scheme**

The present research work has been divided into 7 chapters.

**CHAPTER-I** as conventionally, deals with the **Introduction**. It articulates the importance, problems of the study, its aim and object. It introduces a conceptual background. It also describes the research methodology.

**CHAPTER-II** Describe the **Corporate Governance** and its need in present scenario and Report of Various Committee on Corporate governance and what is need and object of corporate Governance and its importance for preventing corporate fraud. When there would be Good corporate Governance there would not be any fraud.

**CHAPTER-III** Deals with **Corporate Securities** in corporate dealt by various participants. The corporate fraud is committed in respect of security. Without defining corporate Securities the thesis would be a kite without its string. So the chapter defines the various types of securities and their advantage and disadvantage and the difference between these securities and which type of risk is attached to the security.

**CHAPTER-IV** Deals with **Corporate Frauds in India**. The chapter gives a overview of various frauds committed in India and reasons for these frauds and their effect upon the society. This chapter defines how the corporate fraud affects the whole society and why the common people try to avoid investing their money in market.
CHAPTER-V Deals with **Financial Markets in India**. It defines what are the factors which affect the financial Market. This chapter also defines Primary Market, Secondary Market their difference, listing of Securities and what the advantage of this listing is. It also defines derivates Market and Government security and importance of financial market in India.

**CHAPTER-VI** deals with **Legislations and Regulatory Bodies for Prevention of Corporate Frauds in India**. The reasons for the enactment of these act and its implementation and various authorities constituted under the act for preventing corporate frauds and their roles in corporate world.

**CHAPTER-VII** deals with **Conclusion and Suggestions**. Since attempt to present a clear picture of the research subject cannot be said to be complete without identifying the challenges to that field and the suggestion to overcome the deficiencies. I have made this humble effort to enlist few purposeful and relevant suggestions which emerged out of the analysis in previous chapter and finally in conclusion.