FTI CONSULTING

Improving Disclosure Standards in Indian Capital Markets

How Publicly Listed Indian Corporations Can Succeed in the Rapidly Changing Environment

In India, regulators, institutional investors and corporate management teams are beginning to understand that ambitions to become the third largest global economy by 2020 cannot be realised with extant – and outdated – practices of disclosure and governance in the capital markets. Indeed, the once embraced principle of 'disclosure only to the level mandated by law' is slowly giving way to the principle of 'voluntary disclosure' and greater overall transparency.

While not a widespread practice yet, the reticence of Indian leaders to share information and business strategies is beginning to change, at least amongst the large-cap corporates. Growing ranks of Indian corporations are realising that the competition for capital is global, driven in large part by more vocal investors who are raising the bar on transparency, disclosure and investor relations practices. To be sure, today in India there is a greater appreciation of the fact that better governed companies in other emerging or frontier markets will attract capital away from poorly governed cousins. This said, laws and behaviors are therefore slowly beginning to change.

In short, a general shift in the Indian capital markets is underway and this shift is shedding light on new risks that Indian management teams and boards of directors will need to manage and mitigate. Undoubtedly, new practices will be required to support shifting attitudes and navigate evolving regulations.

The Historical Perspective

With over 5000 listed entities, India has the largest number of publicly listed corporates in the world.[1] Yet only one in ten of them is actively traded. The rest languish as small-cap equities, under-researched, less understood and prone to manipulation by speculative traders.

While going public has been, at least in principle, a sign of business maturity, in practice it has also for too long been seen as a convenient channel for access to public funds without needing to worry about the accountability that accompanies it. As one specific example, private equity players have routinely encountered entrepreneurs who have over-leveraged their business, expanding ahead of capacity and tapped the capital markets as a source of cheap funds, only to stumble under the pressure of quarterly performance and public scrutiny. Too many entrepreneurs are in a hurry to tap the capital markets, without adequate preparation or rationale. It is a well beaten path that has rewarded many a promoter, broker and merchant banker, at the expense of individual investors who understand little about the business that they are coaxed to put their money into. At least, until very recently.

The US$860 million Harshad Mehta securities scam (involving massive share price manipulation of listed companies in India using bank deposit receipts) brought the matter of stock market manipulation as a get-rich-quick route into the public consciousness. A number of regulatory actions were implemented to protect the sanctity of securities markets after this event. Many committees, securities scams and regulatory amendments later, it was proposed that the governing legislation regulating the corporate entities in India – The Companies Act of 1956 passed into law in the year that it bears in its name – needed an overhaul. This was helped, not in small measure, by the US$2bn Satyam accounting scandal in 2009. The Satyam scandal was a national embarrassment triggered by confessions from the promoter, a celebrated role model for Indian entrepreneurship, for perpetuating a multi-year fraud despite having purported strong corporate governance standards, an independent board and a Big Four auditor.

Recent Developments

A couple of developments indicate that there will be a trend towards greater transparency in the Indian capital markets in the next few years. This is the result of a combination of

[1] World Federation of Exchange (WFE) record as of Dec 2012

factors - fresh regulations, a more empowered markets regulator and assertive institutional investors.

New Legislation is Pending

Building on the changes, 2013 is expected to be an important year in which two significant regulatory milestones will occur: the passage of the new Companies Bill into law and the adoption of Financial Sector Legislative Reforms Commission (FSLRC) recommendations.

The new Companies Bill covers unprecedented ground and is expected to bring corporate regulation up-to-date and on par with best international practices. It has a strong focus on Board independence, protection of minority shareholders, accountability of independent directors and socially responsible behavior. The FSLRC recommendations (or Indian Financial Code, as they are referred to) focus on protection of financial consumer rights, micro-prudential norms (including regulation of governance and management) and simplifying the complex architecture of multiple regulations and regulators that currently oversee the financial markets. Both changes, once implemented, will mark a significant step forward for the regulatory framework in India.

The Securities and Exchange Board of India (SEBI) is Raising the Bar

At the same time, the Securities and Exchange Board of India (SEBI), the capital markets regulator, has been making some quite significant moves:

- SEBI has been taking a closer look at its practice of consent order rulings to settle disputes with erring parties, a system that has come under criticism for allowing companies that run afoul of disclosure regulations to be let off with a token fee without 'admittance or denial of guilt.' From last year, the consent order mechanism has excluded insider trading violations, front running and a failure to make an open offer during takeovers from its purview.
- SEBI is also modernizing, with the help of external advisors, to bring it at par with its international peers and strengthen its enforcement capabilities. Indian entities have traditionally taken advantage of SEBI's relatively lean enforcement capacity and prosecution limitations to continue with violations in the absence of a real deterrence.

India's Financial Regulatory Architecture – Existing and Proposed Structure

The FSLRC was constituted by the Government of India in March 2011 to review and recast the legal and institutional structures of the financial sector in India – to align the 60 Legislative Acts and multiple regulations that govern the financial sector, and reduce regulatory gaps, overlaps, inconsistencies and regulatory arbitrage. The table below displays the FSLRC's recommendations:

Existing Agencies	Responsibility	Agencies Proposed by FSLRC	Proposed Responsibility
1. Reserve Bank of India (RBI)	The central bank, responsible for national monetary policy.	1. Reserve Bank of India (RBI)	Monetary policy, regulation of banking and payment systems in enforcing proposed consumer protection and micro-prudential law.
	Part responsible for public debt management (with Central Government).	2. Public Debt Management Agency (PDMA)	An independent public debt management office.
2. Securities Exchange Board of India (SEBI)	Securities markets regulator.	3. Unified Financial Agency (UFA)	Implementation of consumer protection and micro-prudential law for all financial firms other than banking and payments. Will unify the regulation and supervision of all financial firms such as mutual funds, insurance companies and firms which are not banks or payment providers.
3. Insurance Regulatory & Development Authority (IRDA)	Insurance sector regulator.		
4. Forward Markets Commission (FMC)	Commodity futures markets regulator.		
5. Pension Fund Regulatory & Development Authority (PFRDA)	Pension sector regulator, responsible for pensionary reforms.		
6. Securities Appellate Tribunal (SAT)	Appellate body against orders passed by capital markets regulator SEBI.	4. Financial Sector Appellate Tribunal (FSAT)	SAT to be subsumed in FSAT - will hear appeals against all financial regulatory agencies.
7. Deposit Insurance and Credit Guarantee Corporation (DICGC)	RBI subsidiary provides deposit insurance for bank depositors against loss of deposits from bank failures.	5. Resolution Corporation (RC)	The present DICGC will be subsumed into RC - will work across the financial system.
8. Financial Stability and Development Council (FSDC)	Coordination between financial market regulators.	6. FSDC	Statutory status - will be responsible for systemic risk oversight.
		7. Financial Redressal Agency (FRA)	Will addresses consumer complaints across the entire financial system.

- Recently there has been far greater enforcement action against politically-connected Indian business groups that is forcing Indian boards and managements to re-evaluate governance practices. The Sahara case is an interesting example. SEBI chastised the Sahara Group in March 2013 for collecting small-ticket funds from individual retail investors in violation of regulations. When instructed to refund individual investors, the Sahara Group sent 128 truck-loads of paper receipts claiming to have returned money to retail investors on an investment scheme that should not have been marketed in the first place, followed by full page advertisements in the national daily media publications with allegation of being a witch-hunt victim. SEBI has dug its heels in, bringing in external advisors to process the documents and handing the bill back to the business group.
- SEBI is also seeking to make amendments to the regulation that governs itself, The SEBI Act of 1992, to give it greater powers of enforcement to go after violators even as it reviews its corporate governance framework and its two-decade old insider trading rules.
- Lastly, while the Indian bourses are littered with public corporations and promoters that continue to hold majority-ownership, SEBI has mandated a minimum public holding of 25 percent across all listed companies in a bid to reduce the level of promoter interest and potential conflict of interest issues. Companies who have failed to comply are being penalized.

Institutional Investors are Demanding More out of Indian Corporates

Finally, international institutional investors have started to demand corporate and management behavior in line with those in developed markets. Late last year, activist investor The Children's Investment (TCI) Fund filed litigation against the directors of state-owned, monopoly fuel supplier Coal India for not fulfilling their fiduciary duty and protecting the interests of minority shareholders by allowing its dominant shareholder, the Government of India, to dictate coal prices. The litigation dragged the government into its ambit on the grounds of abusing its powers as a majority stakeholder, leaving the Coal Minister rather distressed as he struggled to explain how the situation was unprecedented. The litigation against the management and the government has become a milestone and a clear sign that even the sovereign and monopolies can be challenged by investors.

Interestingly, the new Companies Bill provides for class-action suits against management by minority investors, an under-estimated but potent resource in the hands of institutional investors.

The Path Ahead – How Should Management Teams Move Forward?

The eco-system of regulatory controls, progressive boards and engaged minority investors is just about coming together in India. As this takes shape, it will be critical for Indian issuers to be prepared to operate in a new paradigm. FTI Consulting can advise senior management of listed companies on adapting to the new environment in three distinct ways:

1. ***Helping Indian Companies Communicate Beyond 'Only Mandatory' Disclosure Parameters***
   Management teams have to change the manner in which they communicate, particularly about financial performance, to the capital markets and the financial press. The emphasis on non-financial metrics and business strategy during earnings announcements is gaining prominence. Investor relations advisors at FTI Consulting can work with CFOs of listed Indian companies to ensure that the investor narrative is compelling and appreciated by analysts covering the respective sector. This assumes significance when earning numbers are presented as a vindication of sound business strategy and management capability.

2. ***Building Bridges to International Institutional Investors***
   Expanding the investor base and attracting long-term investors is every CFO's dream. The entry of institutional investors can do wonders for a company's valuation and share performance. However, international institutional investors also follow global benchmarks – of performance, disclosure and reporting standards. FTI Consulting advisors regularly track institutional investor sentiments, particularly amongst emerging market funds and investors. This allows us to advise management team on their international investor targeting and engagement strategies.

3. ***Helping Indian Companies Identify Vulnerabilities and Mitigate the Risks to Enterprise Value***
   An outside-in advisory perspective can be invaluable in anticipating market disruptions and enterprise risks – whether they emanate from a disrupted supply chain, an international litigation, leadership transition, policy changes, an acquisition, a boardroom battle or corporate governance failings. FTI Consulting advisors can engage with Indian boards and management teams, helping them identify such enterprise risks and mitigate their impact when they do occur. In addition to ongoing counsel, our advisors help build crisis handling and communication preparedness capacity amongst senior management team members.

In India, as in most emerging markets, opaque investor communication is a proxy for poor corporate governance, at worst, or an indifferent CFO, at best. We believe Indian companies are beginning to understand the risks of such oversight. Over time, investors will appreciate and reward management teams that have taken the effort to understand and manage such risks in the quickly evolving environment.

MUMBAI
Amrit Singh Deo
+91.9167.428242
amrit.singhdeo@fticonsulting.com

CRITICAL THINKING
AT THE CRITICAL TIME™

About FTI Consulting

FTI Consulting, Inc. is a global business advisory firm dedicated to helping organisations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. FTI Consulting professionals, who are located in all major business centers throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges in areas such as investigations, litigation, mergers and acquisitions, regulatory issues, reputation management and restructuring.

www.fticonsulting.com