INDIA HAS A LONG WAY TO GO IN TACKLING CORPORATE FRAUD

THE EXISTING LAW AND REGULATORY FRAMEWORK IS NOT ADEQUATE FOR THE DETECTION AND PREVENTION OF WHITE COLLAR CRIMES. A LOT REMAINS TO BE DONE IN THIS SPHERE

In recent times, the Jan Lokpal movement has captured popular imagination with its premise of establishing an effective mechanism to prevent and check corruption in the public sphere. However, the resultant 'Anti-Corruption, Grievance Redressal and Whistleblower Protection Bill, 2011' (Jan Lokpal Bill), which is currently being debated by the Parliament, excludes from its purview 'white collar' offences involving the private sector. This issue has recently come into the spotlight with a spurt of alleged frauds involving companies

like Reebok, Liliput Kidswear and On-Mobile making the headlines for all the wrong reasons.

UNDERSTANDING CORPORATE FRAUD—AN INDIAN SUBTEXT

The traditional understanding of corporate fraud as a victimless crime is a misnomer, and there is a compelling need to crackdown on such offences, as these affect stakeholders ranging from shareholders, employees, business partners, and may even extend to society at large.

Further, the damage often goes beyond just direct losses attributable to the fraudulent activity. When instances of failure of corporate governance are detected, the public perception of the company in question takes a severe 'hit' with the ensuing erosion of market value and future revenues being practically impossible to estimate. These instances could create a negative perception about India as a business environment, and also have grave repercussions on the long term growth trajectory of the economy. This becomes especially crucial as India, to a substantial extent, relies on attracting external investment to fuel its ambitious development projects.

THE LAW AS IT STANDS

Currently, tackling corporate fraud in India is akin to fitting a square peg in a round hole. Due to the lack of specific statutory provisions in the Companies Act, 1956 (Companies Act) or the Indian Penal Code, 1860 (IPC), the offence is prosecuted under a variety of heads, depending on the facts of the case. For instance, in the recent Reebok case, the police has reportedly filed a case against the accused former officers of the company under several provisions of the IPC such as Sections 406 and 408 (criminal breach of trust), 418 (cheating with knowledge of ensuing wrongful loss) and 477A (falsification of accounts).

GRIDLOCK

Another drawback of India's regulatory framework is the occurrence of regulatory overlap with more than one agency entitled to investigate an event of white collar crime. When the

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Madras High Court issued notices to the Serious Fraud Investigation Office (SFIO) and the Central Bureau of Investigation to investigate the allegation that the merger of Reliance Power with Reliance Natural Resources Limited constituted a fraud on share holders, both agencies indicated the matter was being looked at by the Securities and Exchange Board of India (SEBI). The SEBI for its part referred the matter right back to the SFIO, given that it is a specialized body created with a mandate to investigate economic frauds and white collar crimes. This avoidable situation of pinball played out between agencies is but the tip of the iceberg of bureaucratic red tape.

SOLVING THE REGULATORY GRIDLOCK

The Companies Bill, 2011 (Companies Bill) proposes to resolve this current regulatory gridlock by designating the SFIO as the agency to investigate corporate fraud. The SFIO was created in 2003, pursuant to a resolution passed by the Union Cabinet. It has been under the administrative control of the Ministry of Corporate Affairs, and came into prominence in 2009 while investigating the Satyam scam. The SFIO has now been mandated to conduct a probe into the Reebok matter.

The Parliamentary Standing Committee on Finance has also heeded the request that the SFIO be granted wider powers so as to better execute its functions. In their review of the Companies Bill, the Standing Committee recommended that the SFIO be empowered to take cognizance and initiate investigation into any instance of corporate fraud. This would greatly enhance the efficacy of the agency and ensure it has the bite to back its bark.

WHISTLE BLOWING

Like charity, vigilance against corporate fraud begins at home. Employees and company insiders privy to the day-to-day affairs of the company are often the first to detect perpetuation of such activities.

For those in the know to divulge information to higher-ups or even outside authorities, it is critical to create a secure environment which provides confidence to a whistleblower that his identity will be kept confidential and that he will not be victimised. Given that India does not yet have a law on protecting whistleblowers, and that both the Public Interest Disclosure and Protection to Persons Making the Disclosure Bill, 2010, and the Jan Lokpal Bill are still pending enactment, the legislative inertia on this issue is regrettable.

While protection proposed to be afforded to whistleblowers, under both the above bills only extends to the public sphere, the Companies Bill proposes to create a vigilance mechanism which aids whistleblowers. However, the fine print as to this mechanism is still awaited as is the extent of its applicability, which in the Companies Bill is currently limited to listed companies and '...such other classes of companies, as may be prescribed.' Notably, the listing agreement provides for a voluntary obligation on

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listed companies to formulate a policy to protect employees reporting unethical acts.

Despite these drawbacks, whistleblowing has had a stellar role to play in the history of Indian corporate governance with Satyam and Liliput Kidswear being two notable instances where the lid on on-going fraudulent activities was blown off by anonymous sources.

INDEPENDENT DIRECTORS—THE PRICE OF ETERNAL VIGILANCE

The presence of independent directors in the boards of companies has been universally accepted as a good corporate governance measure as they are presumed to represent the interests of minority shareholders and ensure transparency and external objectivity in the decision making process. Of late, questions are being raised as to the degree of supposed independence of these directors and whether their presence is a mere token.

The Companies Bill seeks to dispel these notions by devoting an entire schedule to independent directors, setting out in great detail who are eligible to be considered as independent directors, the mechanism for their appointment, duration of their tenure as well as their duties and obligations.

A positive proposal in this connection is the clarity on the extent of liability of independent directors. This is limited only to matters which have occurred with their knowledge, which may be attributable to such directors by virtue of being privy to board deliberations, or where they have failed to act in a diligent manner. This is in line with the clarification issued by the Ministry of Corporate Affairs to take adequate care while initiating proceedings in instances where independent directors were identified as the officer in default.

Such measures are welcome as it would enable activist directors to perform their duties freely without the added pressure of being automatically considered as possessing knowledge of wrongful activity in the company solely by virtue of membership to the board.

AUDITORS—A RECIPE TO OBVIATE COOKING THE BOOKS

Traditionally, auditors have played a key role in ensuring that the financials of the company strictly comply with Indian auditing standards. However, in recent times, instances of auditors working hand in glove with errant members of the company have brought in sharp focus the danger of automatically equating an external audit to a purely independent exercise.

The Companies Bill in its present avatar seeks significant changes to the law pertaining to auditors. This includes mandatory rotation of auditors (for listed companies and other companies 'as may be prescribed'), who are now not permitted to be reappointed for successive terms, in case of an individual auditor, or more than two successive terms, in case of an auditing firm. The Companies Bill also provides for more than one auditor to inspect and review the books of accounts of a company. While there are suggestions that a prolonged tenure could adversely affect the independence of the external auditor, the number of auditing firms operating on a countrywide scale is limited, therefore restricting choice in this matter.

The Company Law Tribunal has also been granted the power to direct a company to change its auditors if it is satisfied that the auditor has attempted, abetted or colluded in fraud. Auditors convicted of such an offence would be liable to face civil and criminal proceedings punishable with a fine of up to three times the amount or imprisonment for up to a maximum term of ten years; such auditors would also not be eligible for appointment as auditors for a period of five years from the date of the order. Additionally, the tribunal shall have the right to exercise this power either upon receipt of a complaint or of its own accord. It is hoped the introduction of such stringent penalties would have a deterrent effect on auditors.

PROGRESSING TO A PROACTIVE REGIME

The role of external agencies is generally limited to post facto investigation, almost inevitably after the fraudulent activity has been perpetrated. Detection and prevention of fraud is, therefore, best accomplished by ensuring vigilant internal systems in combination with periodic external review.

The use of technology as a monitoring mechanism can also lead to detection and prevention of fraud at an early stage. While the passage of the Companies Bill is expected to have a considerable impact on deterring fraud, there is still no clarity as to its final form or when it will come into effect. In the interim, Indian companies are waking up to the idea that money invested in creating infrastructure, such as an anonymous hotline for whistleblowers and information technology surveillance for data protection, may be a worthwhile bargain in the long run, considering their potential in preventing future losses. However, regulators may still need to act as a tipping point and compel laggards to create a transparent and proactive corporate culture.

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